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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936

No. 257

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

THE MIDLAND MUTUAL LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 4, 1936

CERTIORARI GRANTED OCTOBER 12, 1936

SUPREME COURT OF THE UNITED STATES

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104782—36——1

Before United States Board of Tax Appeals

Docket No. 71730

THE MIDLAND MUTUAL LIFE INSURANCE CO., PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances:

For Petitioner: Carl J. Purpus, Esq., F. J. Wright, Esq.,
For Respondent: A. Carnduff, Esq.

Docket entries

1933

May 1—Petition received and filed. Taxpayer notified. (Fee paid.)
May 1—Copy of petition served on general counsel.
June 12—Answer filed by general counsel.
June 21—Copy of answer served on taxpayer.
Nov. 8—Hearing set Dec. 14, 1933.
Nov. 13—Motion to place on circuit calendar for hearing in Columbus, Ohio, filed by taxpayer.
Nov. 14—Motion of 11-13-33 denied.
Dec. 14—Hearing had before Mr. Morris on merits—submitted. Appearance of F. J. Wright and stipulation of facts filed. Petitioner's brief due 1-15-34.
Dec. 20—Transcript of hearing of Dec. 14, 1933, filed.

1934

Jan. 12—Memorandum of authorities filed by general counsel.
Jan. 13—Brief filed by taxpayer. 1-15-34 copy served on general counsel.
Sept. 11—Memorandum opinion rendered—Logan Morris, Division 14. Judgment will be entered for the respondent.
Sept. 12—Decision entered—Division 14, Logan Morris.
Dec. 3—Supersedeas bond in the amount of $2,500.00 approved and ordered filed.
Dec. 3—Petition for review by U. S. Circuit Court of Appeals (6) with assignments of error filed by taxpayer.
Dec. 3—Praecipe filed.
Dec. 3—Statement of evidence lodged.
Dec. 4—Proof of service of petition and praecipe filed.
Dec. 13—Notice of lodgement of statement with hearing notice 12-26-34 filed.
Dec. 26—Hearing had before Mr. Black on approval of statement of evidence—referred to Mr. Morris for approval.
Dec. 27—Statement of evidence approved and ordered filed.

Before United States Board of Tax Appeals

Petition

Filed May 1, 1933

The above named petitioner hereby petitions for a redetermination of a deficiency assessment as set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (IT:AR:C–6–RWC–60D) dated March 3, 1933, and as a basis of its proceeding alleges as follows:

1. The petitioner, The Midland Mutual Life Insurance Company, is a corporation with its principal place of business in the Huntington Bank Building, Number 17 South High Street, Columbus, Ohio.

2. The Notice of Deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on March 3, 1933.

3. The tax in controversy is an income tax deficiency for the calendar year 1930 of $1,232.22.

4. The determination of tax set forth in said Notice of Deficiency is based upon the following errors:

(a) The commissioner erred in refusing to permit the petitioner to deduct from net income for the year 1930, and in adding to the net income of the petitioner for the year 1930 as interest received on mortgage loans the sum of $5,456.99.

3 5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The taxpayer did not receive in the year 1930 interest on mortgage loans on properties Nos. 6, 7, 10, 11, 13, and 15 in the total amount of $5,456.99 as found and determined by the Commissioner, or any other amount. Said sum represents the total amount of interest due but unpaid to the taxpayer at the time of the foreclosure sales which was included in the bid price of the respective properties at such foreclosure sales. The books of the taxpayer do not show the receipt of such amount of interest on such mortgage loans in the year 1930 and the same does not constitute income in said year.

(b) At the time title to said properties was acquired by the taxpayer and said properties were transferred to the real estate accounts of the taxpayer there was not included in the book value of any of such properties any amount for accrued interest. At such time the book value of each of said properties included only the unpaid principal of the loan thereon and the actual disbursements that had been made on account of such properties by the taxpayer, including taxes and expenses at or prior to the acquisition of title, as the case may be, court costs and attorneys fees in connection with such foreclosure (see Exhibit A attached to the Commissioner's letter of March 3, 1933).

(c) Properties Nos. 6, 10, 11, and 13 are all located in the City of Detroit, Michigan. Under the laws of the State of Michigan

followed by the taxpayer in foreclosing mortgages in that state, the mortgagor is allowed one year from the date of the foreclosure sale within which he may redeem the property by paying to the purchaser the amount bid for the property at such sale, even though the amount of such bid be less than the total amount of the mortgagee's investment in the property. The purchaser cannot, under the law, acquire title until after the expiration of the redemption period. In the case of each of said properties the taxpayer (mortgagee) was the only bidder, and in order to protect itself from loss through redemption of the mortgaged premises, and entirely irrespective of the value of the property, the taxpayer was forced to bid at foreclosure sale the amount of its total investment therein, including principal amount, interest, taxes, court costs, attorney fees, and other charges then accrued. If the properties are redeemed during the redemption period, taxes and insurance premiums accruing during such period cannot, if paid by the mortgagee, be collected from the mortgagor.

(d) The mortgagee in mortgages on Michigan real estate does not acquire title to the mortgaged premises bid in at foreclosure sale until one year from the date of sale. Therefore, the value of the mortgaged property at the date of the acquisition of title should be considered rather than the value at the date of sale. The market values of the respective Michigan properties were substantially less in 1930 than on the respective dates of sale of sale properties. The petitioner denies that any interest income, based on the value of the property at any date, was or is received or subject to tax.

(e) Properties Nos. 7 and 15 are located in the Cities of Canton, Ohio, and Lima, Ohio, respectively. Under the laws of Ohio foreclosures are instituted by filing a petition and causing a summons to be issued thereon. At the expiration of the time for answer, if the mortgagor is in default for answer, or after hearing if answer is filed, a decree of foreclosure is entered. No redemption period is fixed by statute, but the court fixes a redemption period usually from three days to a week. Thereafter an order of sale issues to the sheriff of the county in which the premises are located who, after due advertisement thereof, offers the same for sale. Entirely irrespective of the value of the property, the mortgagee customarily bids the property at the lowest amount permitted by law so as to avoid the additional costs and expenses which would be incurred by readvertising and reoffering of said property for sale. In other words, the amount at which the property is bid in by the mortgagee has no relation to the value of the property, but the bid is made for the purpose of obtaining title promptly by the mortgagee and to avoid the additional costs and expenses above referred to.

(f) In all cases in determining market values, consideration should be given to the fact that the taxpayer would, on resale of the respective properties, be compelled to pay sales commissions which amount to 5% in Detroit, Michigan, and Lima, Ohio, and 4% in Canton, Ohio.

Wherefore the petitioner prays that this Board may hear the proceedings and redetermine the deficiency herein resisted and for such other relief to which the petitioner may be found to be entitled.

CARL J. PURPUS,
Counsel for Petitioner,
Huntington Bank Bldg., Columbus, Ohio.

5 *Duly sworn to by H. B. Arnold; jurat omitted in printing.*

Exhibit A to petition

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, March 3, 1933.

THE MIDLAND MUTUAL LIFE INSURANCE COMPANY,
12th Floor, Huntington Bank Building, Columbus, Ohio.

SIR: Your are advised that the determination of your tax liability for the year 1930, discloses a deficiency of $1,232.22, as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928,
6 notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

However, If You Do Not Desire To Petition, you are requested to execute the inclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this form will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the inclosed form, or on the date assessment is made, whichever is earlier; Whereas If This Form Is Not Filed, interest will accumulate to the date of assessment of the deficiency.

Respectfully,

DAVID BURNET,
Commissioner.
By W. SHERWOOD,
Acting Deputy Commissioner.

Inclosures:
Statement
Form 870
Schedules 1 and 2
Exhibit A

Statement

IT:AR:C–6
RWC–60D

In re: The Midland Mutual Life Insurance Company, Columbus, Ohio

Income tax liability

Year	Income tax liability	Income tax assessed	Deficiency
1930	$30,945.54	$29,713.32	$1,232.22

The adjustments producing the result stated above are based on a revenue agent's report, a copy of which has been furnished you, and are explained in the attached schedules 1 and 2 and Exhibit A.

Careful consideration has been given to your protest dated October 31, 1932, filed with the internal revenue agent in charge, Cincinnati, Ohio, and to your protest executed February 2, 1933, addressed to the Commissioner of Internal Revenue, Washington, D. C.

The Midland Mutual Life Insurance Company. Year ended December 31, 1930

Schedule 1.—Adjustments to Net Income

Net income as disclosed by return		$247,611.00
As corrected		257,879.51
Net adjustment as computed below		$10,268.51
Unallowable deductions and additional income:		
(a) Interest on Mortgage loans	$5,456.99	
(b) Taxes	2,830.76	
(c) Interest on income tax refunds	2,282.81	
Total	$10,570.56	
Nontaxable income and additional deductions:		
(d) Interest on mortgage loans	302.05	
Net adjustment as above		$10,268.51

Schedule 1–A.—Explanations of Items

(a) Interest on mortgage loans.

Where a company forecloses a mortgage, upon which both principal and interest are due and unpaid, and buys in the property for the face value of the mortgage, it has received no gross income. (John Hancock Mutual Life Insurance Company, 10 B. T. A. 736.) However, if it is bid in at the face value of the mortgage, plus accrued interest and expenses the Bureau holds that the accrued interest should be accounted for as accrued. Where properties are ac-

quired from borrowers through deeds voluntarily made to the company, it is considered full satisfaction has been made of all principal and interest, and the accrued interest should be accounted for.

See exhibit A, last column, for details of computation made in accordance with the above.

(b) Taxes.

In real estate taxes deducted in return there was included as
8 deductions taxes paid at the end of the redemption period on property acquired in Michigan. These items should have been added to cost of properties, and are therefore disallowed as deductions. See exhibit A, column 5, for details.

(c) Interest on income tax refunds is taxable and is therefore restored to income.

(d) Interest on mortgage loans.

This item represents interest included in income in error. See exhibit A, next to last column for details.

Schedule 2.—Computation of Tax, 1930—Income Tax

Net income for taxable year	$257,879.51
Income tax 12%	30,945.54
Total previously assessed, No. 400245	29,713.32
Additional tax to the assessed	1,232.22

IT:AR:C-6
RWC-60D

Exhibit A to notice of deficiency

In re: The Midland Mutual Life Insurance Company, Columbus, Ohio

Real estate acquired year ended December 31, 1930

Property number	Mortgage loan number	Unpaid principal of loan	Taxes and expense prior to and at time of foreclosure, court costs, attorney fees, etc. (capitalized on books)	Taxes paid at expiration of period of redemption covering period of redemption (charged to "Real estate expense" in error)	Attorney fees charged legal expense in error. Not deducted on return—but should be included in cost basis of property	Cost basis	Accrued interest added to interest earned on books and return in error	Book value	How acquired	Bid price of a judicial sale	Accrued interest to date acquired	Interest included in income on return in	Interest to be added to taxable income
6	931	$8,500.00	$701.35	$304.86	$84.75	$9,590.96		[a] $9,148.35	Jud. sale	$10,192.08	$1,275.00		$601.12
7	1093	9,900.00	651.65			10,551.65		10,551.65	Jud. sale	11,000.00	897.60		448.35
8	1162	20,000.00				20,000.00		20,000.00	Jud. sale	22,000.00			
9	1371	28,225.00				28,225.00		28,225.00	Jud. sale	20,000.00	2,012.40		575.66
10	1350	15,000.00	772.07	628.15		16,400.22		[b] 15,772.07	Jud. sale	16,975.88	2,010.00		1,389.61
11	1326	15,000.00	1,200.53	536.89		16,737.42		[c] 16,200.53	Jud. sale	18,127.03	2,075.00		
12	807	5,053.25	1,000.09			6,653.34	$302.05	[d] 6,955.39	Jud. sale	6,560.00	302.05	$302.05	1,641.49
13	1470	34,200.00	2,046.22	1,360.86		37,607.08		[e] 36,246.22	Jud. sale	39,251.57	4,731.00		
14	1657	4,000.00	404.62			4,404.62		4,404.62	Jud. sale	4,000.00	164.60		797.76
15	623	30,000.00	2,165.82		370.42	32,536.24		[f] 11,913.31	Jud. sale	33,334.00	4,559.00		
	1477	9,498.80	248.69			9,747.49			Jud. sale	3,333.34	807.42		
				$2,830.76	$455.17							$302.05	$5,456.99

	a	b	c	d	e	
Book value	$9,148.35	$15,772.07	$16,200.53	$6,955.39	$36,246.22	$41,913.31
Add:						
Taxes charged to expense in error—should be capitalized	304.86	628.15	536.89		1,360.88	
Legal expense charged to expense in error—should be capitalized	84.75					370.42
Error in account	[1] 53.00					
Deduct:						
Interest capitalized in error				302.05		
Cost basis	$9,590.96	$16,400.22	$16,737.42	$6,653.34	$37,607.08	$42,283.73

[1] In 1930, $53.00 was credited against these items capitalized. This was in error, and in 1931 the entry was reversed. The book value as at Dec. 31, 1930, reflected the lower value in error. This has been adjusted in this report.

10 Before United States Board of Tax Appeals

Answer

Filed June 12, 1933

Now comes the Commissioner of Internal Revenue, the respondent herein, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, and for answer to the petition heretofore filed in this proceeding admits and denies as follows:

1, 2, and 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4 (a) Denies the errors alleged in subparagraph (a) of paragraph 4 of the petition.

5 (a)-(f) For lack of information upon which to base relief denies the allegations contained in subparagraphs (a) to (f) inclusive of paragraph 5 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinabove expressly admitted, qualified, or denied.

Wherefore, it is prayed that the petition be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
L. W. CREASON,
Special Attorney,
Bureau of Internal Revenue.
6/10/33 RD.

11 Before United States Board of Tax Appeals

Memorandum opinion

Entered Sep. 11, 1934

MORRIS: The respondent having determined a deficiency in income tax of $1,232.22 for the calendar year 1930, the petitioner brings this proceeding for the redetermination thereof alleging error in such determination by reason of the refusal to permit a deduction of $5,456.99 in the computation of net taxable income for the year 1930, and in adding said amount to such net income as interest received on mortgage loans.

The petitioner is a corporation organized and existing under and by virtue of the laws of the State of Ohio with its principal place of business at 17 South High Street, Columbus, Ohio.

In his determination of the deficiency the respondent increased the taxable net income as reported by the petitioner in the amount

of $10,570.56. Such increase so added to the income reported consisted inter alia of the sum of $5,456.99 interest on mortgage loans.

During the year 1930 there was due this petitioner upon said loans secured by mortgages on real estate in the State of Michigan and Ohio, interest in the amount of $5,456.99. The books of the petitioner are, and were during the year 1930, kept on a calendar year cash basis and show in each year, including the year 1930, the cash receipts and disbursements on account of the various items of investments contained in the petitioner's assets. Only payments of interest which are, and were during the year 1930, actually made to and received by the petitioner are and were entered on the books and records the petitioner. Said loans then being in default, the petitioner during said year foreclosed its mortgages upon the real estate described in said mortgages and at the sale on foreclosure during the year 1930 did bid in, and acquire at said foreclosure sales, the said properties for amounts which were the total amounts of the principal of said loans plus the interest thereon, being $5,456.99. Upon receipt of the title to said properties so acquired by foreclosure and bid in by the mortgagee, which was this petitioner, during the year 1930, the investments were transferred on the books of the petitioner from the mortgage loan account to the real estate account of the petitioner and were carried thereon as assets of the petitioner at amounts which were equal to the principal amounts of the loans secured by said mortgages so foreclosed plus any disbursements made by the petitioner for taxes, court costs, attorney fees or insurance pre-
12 miums for the preservation of said properties, but the amount of interest included in the bid at said foreclosure sales was not carried upon the books of this petitioner as a part of the cost of said properties or as an asset of this petitioner. That is to say, the investments, on the books of the petitioner, in each of said properties so acquired included only the unpaid principal of the loan thereon and disbursements as aforesaid and did not include the interest upon said principal. Nor did the petitioner include such interest in its assets in its annual statement or convention report for the year 1930.

The instructions issued to the petitioner's representatives who have charge of the foreclosure of mortgages, in states where a period of redemption is allowed (all of the properties herein concerned being in such states) are to bid at the sale under such foreclosure proceedings in behalf of the petitioner such sum as will enable the petitioner to realize no loss on account of its investment in case a redemption should be made from the foreclosure sale and bids were and have been made accordingly. Such bids were made in 1930 in respect of said foreclosures without regard to the actual value of the property sold at such foreclosure sales, but with a view of protecting the investment in case of redemption, and there was then included in the amounts bid on behalf of the petitioner the interest which had accrued and had not been paid on the loan at the time of the foreclosure sale. The interest item included in the bid at such foreclosure sales has

never been entered on the books of the petitioner or otherwise treated by the petitioner as income. There was no competitive bidding at any of said foreclosure sales and the petitioner was the only bidder at such sales.

The properties which were acquired in said foreclosure proceedings, with dates thereof and the amounts bid by the petitioner, are as follows:

Location	Petitioner's mortgage loan number and name of mortgagee	Date of bid	Date of acquisition of title	Amount of bid
Detroit, Mich	931—Caruso	Jan. 15, 1929	Jan. 15, 1930	$10,192.08
" "	1350—Ransom	July 22, 1929	July 22, 1930	16,525.88
" "	1326—Hallam	Aug. 6, 1929	Aug. 6, 1930	18,127.03
" "	1179—Harrington	Oct. 19, 1929	Oct. 19, 1930	39,251.57
Canton, Ohio	993—Smith about	Mch. 19, 1930	Mch. 24, 1930	10,351.65
Lima, Ohio	623—Dalk "	Nov. 29, 1930	Dec. 2, 1930	33,334.00

13 Of said sum of $5,456.99 interest, the amount of $4,210.88 was interest due and included in the bid price of the foreclosure but not included in the book values of assets after acquisition of title upon loans secured by real estate located in the State of Michigan.

In determining a part of the deficiency herein the respondent included in taxable net income the said sum of $5,456.99, interest.

The question here presented, that is, whether accrued interest on mortgage loans constitutes taxable income to the petitioner when such interest has been included in the purchase price upon foreclosure of the mortgaged premises, as this petitioner concedes, has been before the Board in Reserve Loan Life Insurance Co., 18 B. T. A. 359, appealed but dismissed January 12, 1932, upon motion of parties, and Missouri State Life Insurance Company, 29 B. T. A. 401, the holding being adverse to the petitioner's contentions. The petitioner attempts to distinguish the instant case, however, on the ground that in those proceedings the petitioners had shown the accrued interest upon their books as income and had treated it as such in their annual statements and convention reports. While it is true that those factors were discussed in those opinions, the courts and this Board have, in a long line of decisions, consistently held that book entries are only evidential, are not conclusive, and furthermore that if the books of account conflict with the actual facts, such actual facts will be followed. Southern Pacific Railroad Company v. Muenter, 260 Fed. 837; Baldwin Locomotive Works v. McCoach, 221 Fed. 59; Harry N. Gifford, 3 B. T. A. 334; Luther Elkins, 12 B. T. A. 1059; Chic Brass Co., 17 B. T. A. 1199. Having already held that such amounts constitute taxable income it becomes unimportant what accounting treatment the petitioner chose to accord them.

The second distinction which the petitioner seeks to draw is that the fair market values of the properties at the date of foreclosure and when titles were acquired were insufficient to cover any part of the accrued interest thereon. This same argument was urged upon the Board in Missouri State Life Insurance Company, supra, which we answer by saying:

* * * "There is much testimony in the record upon the question of the fair market values of the properties acquired. In our view of the situation such question is not material and accordingly no
14 findings are made of those values other than that the fair market values of certain properties were less than the amount of the loan upon such properties plus accrued interest."

We have carefully considered all of the arguments presented in support of the alleged distinctions and believing, as we do, that Missouri State Life Insurance Company, supra, is controlling, and finding no reason to depart therefrom the respondent's determination that such amounts were taxable income must be approved.

Judgment will be entered for the respondent.

Before United States Board of Tax Appeals

Decision

Entered Sept. 12, 1934

Pursuant to the determination of the Board, as set forth in its memorandum opinion entered September 11, 1934, it is

Ordered and Decided: That there is a deficiency of $1,232.22 for the calendar year 1930.

[SEAL] (Signed) LOGAN MORRIS,
Member.

15 Before United States Board of Tax Appeals

Petition for review

Filed Dec. 3, 1934

Now comes the Midland Mutual Life Insurance Company, petitioner herein, and says that the Commissioner of Internal Revenue, respondent herein, determined a deficiency in petitioner's income tax of $1,232.22 for the calendar year 1930; that petitioner then petitioned this Board for a redetermination thereof, alleging error in such determination by reason of respondent's refusal to permit a deduction of $5,456.99 in the computation of net taxable income for the year 1930, and in adding said amount to such net income as interest received on mortgage loans; that this Board on the twelfth day of September, 1934, rendered a decision approving respondent's determination that said amount was taxable income and deciding that said deficiency existed, in which decision there are certain errors prejudicial to this petitioner, to wit:

1. The Board's decision is against the weight of the evidence.
2. The Board's decision is contrary to law.
3. The Board erred in approving respondent's determination and in rendering a decision in this cause for the respondent and against the petitioner.

This petitioner conceiving itself aggrieved by said decision and the errors herein assigned does hereby petition for a review of the decision of said Board in the United States Circuit Court of Appeals for the Sixth Circuit.

Wherefore, this petitioner prays that this review may be allowed and for a correction of the errors complained of; that the amount of the bond on review be fixed; and that the statement of evidence and transcript of the record, proceedings and papers upon which said judgment was rendered be made and duly authenticated, and transmitted and delivered to the clerk of the United States Circuit Court of Appeals for the Sixth Circuit sitting at Cincinnati, Ohio.

(s) FRANCIS J. WRIGHT,
(s) EARL F. MORRIS,
Attorneys for Petitioner.

16 [Duly sworn to by Geo. W. Steinman; jurat omitted in printing.]

Before United States Board of Tax Appeals

Statement of evidence

Lodged Dec. 3, 1934, filed Dec. 27, 1934

Be it remembered, that at the hearing of the above entitled cause before Honorable Logan Morris, Member of the United States Board of Tax Appeals, at Washington, D. C., on the fourteenth day of December 1933, the following proceedings were had:

Appearances: F. J. Wright, Esq., on behalf of Petitioner. Arthur Carnduff, Esq., on behalf of Respondent.

The parties made and entered into the following:

Stipulation of facts

Come now the parties by their respective counsel and stipulate and agree that the following statement of facts may be taken as true without prejudice to the right of either party to introduce further evidence is deemed material:

1. The petitioner is a corporation organized and existing under and by virtue of the laws of the State of Ohio with its principal place of business at 17 South High Street, Columbus, Ohio, and filed its income tax return for the year 1930 with the Collector of Internal Revenue for the Southern District of Ohio at Columbus, Ohio, in the 11th Collection District of Ohio.

2. The Commissioner of Internal Revenue has determined a deficiency in income tax for the year 1930 in the amount of $1,232.22, a part of which is here in issue.

17 3. In his determination of the deficiency the Commissioner increased the taxable net income as reported by the petitioner in the amount of $10,570.58. Such increase so added to the income

reported consisted inter alia of the sum of $5,456.99 interest on mortgage loans, being Item A in the notice of deficiency attached to the petition herein.

During the year 1930 there was due this petitioner upon said loans secured by mortgages on real estate in the States of Michigan and Ohio, interest in the amount of $5,456.99. The books of the petitioner are, and were during the year 1930, kept on a calendar year cash basis and show in each year, including the year 1930, the cash receipts and disbursements on account of the various items of investments contained in the petitioner's assets. Only payments of interest which are, and were during the year 1930, actually made to and received by the petitioner are and were entered on the books and records of the petitioner. Said loans then being in default, the petitioner during said year foreclosed its mortgages upon the real estate described in said mortgages and at the sale on foreclosure during the year 1930 did bid in, and acquire at said foreclosure sales, the said properties for amounts which were the total amounts of the principal of said loans plus the interest thereon, being $5,456.99. Upon receipt of the title to said properties so acquired by foreclosure and bid in by the mortgagee, which was this petitioner, during the year 1930, the investments were transferred on the books of the petitioner from the mortgage loan account to the real estate account of the taxpayer and were carried thereon as assets of the taxpayer at amounts which were equal to the principal amounts of the loans secured by said mortgages so foreclosed plus any disbursements made by the petitioner for taxes, court costs, attorney fees, or insurance premiums for the preservation of said properties, but the amount of interest included in the bid at said foreclosure sales was not carried upon the books of this petitioner as a part of the cost of said properties or as an asset of this petitioner. That is to say, the investments, on the books of the petitioner, in each of said properties so acquired included only the unpaid principal of the loan thereon and disbursements as aforesaid and did not include the interest upon said principal. Nor did the petitioner include such interest in its assets in its annual statement or convention report for the year 1930.

18 The instructions issued to the petitioner's representatives who have charge of the foreclosure of mortgages, in states where a period of redemption is allowed (all of the properties herein concerned being in such states), are to bid at the sale under such foreclosure proceedings in behalf of the petitioner such sum as will enable the petitioner to realize no loss on account of its investment in case a redemption should be made from the foreclosure sale and bids were and have been made accordingly. Such bids were made in 1930 in respect of said foreclosures without regard to the actual value of the property sold at such foreclosure sales, but with a view of protecting the investment in case of redemption, and there was then included in the amounts bid on behalf of the petitioner the interest which had accrued and had not been paid on the loan

at the time of the foreclosure sale. The interest item included in the bid at such foreclosure sales has never been entered on the books of the petitioner or otherwise treated by the petitioner as income. There was no competitive bidding at any of said foreclosure sales and the petitioner was the only bidder at such sales.

The properties which were acquired in said foreclosure proceedings, with dates thereof and the amounts bid by the petitioner, are as follows:

Location	Petitioner's mortgage loan number and name of mortgagee	Date of bid	Date of acquisition of title	Amount of bid
Detroit, Mich	931—Caru	Jan. 15, 1929	Jan. 15, 1930	$10,192.08
" "	1350—Ransom	July 22, 1929	July 22, 1930	16,525.88
" "	1336—Hallam	Aug. 6, 1929	Aug. 6, 1930	18,127.03
" "	1170—Harrington	Oct. 19, 1929	Oct. 19, 1930	39,251.57
Canton, Ohio	1093—Smith about	Mch. 19, 1930	Mch. 24, 1930	10,351.65
Lima, Ohio	623—Dalk "	Nov. 29, 1930	Dec. 2, 1930	33,334.09

Of said sum of $5,456.99 interest, the amount of $1,210.88 was interest due and included in the bid price of the foreclosure but not included in the book values of assets after acquisition of title upon loans secured by real estate located in the State of Michigan.

In determining a part of the deficiency herein at issue the Commissioner included in taxable net income the said sum of $5,456.99, interest.

CARL J. PURPUS,
Counsel for Petitioner.

E. BARRETT PRETTYMAN,
General Counsel, Bureau of Internal Revenue,
Attorney for Respondent.

19 *Petitioner's case*

Thereupon, the petitioner, to maintain the issues on its part, introduced and offered the following evidence, to wit:

C. L. CONVERSE being first duly sworn, testifies as follows:

Direct Examination by Mr. WRIGHT:

My name is C. L. Converse; age 56; residence Columbus, Ohio. My business is that of a real estate broker. I have been in the real estate business since September 1905 at Columbus, Ohio. I have belonged to the Columbus Real Estate Board since its organization. In that connection, I have been a member of the appraisal board for fifteen years. I am a member and past president of the Ohio Appraisal Board. I am a member and have served on several committees of the National Appraisal Board. In my experience as a real estate man during all of these years I have had occasion to a great extent to consider the market values of real estate properties and to

make appraisement of them, and as a member of the appraisal committee of the Columbus Real Estate Board I have made appraisements of real estate in the central part of Ohio. From my experience in considering the values of real estate properties, and making appraisements, I am, in my opinion, competent to testify as to the value of real estate properties.

I am familiar with certain properties located in Detroit, Michigan, which you have referred to in your stipulation as the petitioner's mortgage loan No. 931, the mortgagor's and owner's name being Caruso; and mortgage loan No. 1350, the owner being Ransom; and mortgage loan No. 1926, the owner being Hallam; and mortgage loan No. 1170, the owner being Harrington. With reference to how I became familiar with them and the extent to which my knowledge concerning these properties goes, I will state that in 1921 I took a part-time or *per diem* place with The Midland Mutual Life Insurance Company to inspect their loans on properties out of the City of Columbus. I made trips from three to six times a year, in most of the cities in which they had loans, Detroit, Toledo, Cleveland, Canton, and Lima.

I am familiar with the properties which you have listed in the stipulation at Petitioner's Mortgage Loan No. 1093, the owner being Smith, and the properties in Lima which you have listed as mortgage loan No. 623, the owner being Dalk. I knew them before and after. I have examined, from time to time, all of these properties. I am familiar with their location and the type of properties they are.

From my knowledge of these properties, their location and the type of properties they are, and other facts I have concerning these properties, I am in a position to tell what, in my opinion, the fair market price of those properties, respectively, were in 1929 and 1930. In my opinion the fair market value of the Caruso property on or about January 15, 1929, was $8,500, and on or about January 15, 1930, there was a slight decrease, if anything. In my opinion the value of the Ransom property on or about July 22, 1929, was $15,000, and on or about July 22, 1930, it was practically the same. I have had some additional information in regard to property about that time that it was worth less money than it was in 1929. My opinion as to the value of the Hallam property on or about August 6, 1929, is $16,000, and on or about August 6, 1930, it was practically the same. My opinion as to the fair market value of the Harrington property on or about October 19, 1929, is $37,500, and that on or about October 19, 1930, there had been practically no change. My opinion as to the fair market value of the Smith property in Canton, Ohio, on or about March 24, 1930, is $7,500. My opinion as to the fair market value of the Dalk property in Lima on or about December 2, 1930, is $30,000. I am familiar with these properties as of the present time. They are all still owned by The Midland Mutual Life Insurance Company;

four of them are in different companies, but the stock is controlled by the Midland Mutual Life Insurance Company.

Mr. WRIGHT. Cross-examine.

Cross-examination by Mr. CARNDUFF.

I personally examined each and every one of these six pieces of property, four in Michigan and two in Ohio, during the years 1929 and 1930, and either immediately before or immediately after the time of the foreclosure, when my business called me to Detroit or Lima or Canton or the vicinity of those properties. I remember distinctly that, in regard to Canton, it was probably three or four months after the foreclosure that I reinspected the property.

21 The purpose of my inspection during 1929 and 1930 was simply to keep track of the properties of the Midland, that the Midland had loans on, that were not collected. I knew the unpaid principal amount of that loan or mortgage, approximately, only, at the time I inspected the property. I had an approximate idea of how much was owing to the Midland Company on these properties.

I said I thought the Dalk property was worth $30,000. I do not remember, I do not know, the unpaid amount of the principal of the loan at that time. In explanation, that is a four story brick building 60 by 70 feet. It was a very light construction, which was leased to the Oden Cigar Company and they had tables of women rolling cigars there. Along in 1926 or 1928, the cigar machine came out and that building was of too light structure to carry the machines. The Oden Cigar Company was sold out to a Detroit concern. They took the building. One thing that caused my judgment on that was that an adjoining building had a lease with a clause in it permitting ingress and egress to this building. There is absolutely no way of breaking that lease. They do not have to pay taxes on it, or anything, and still they have the right to go through that building. I do not know how much rent was paid on that building. My estimate was not based on rental because there was none at that time. I do not know the assessed valuation. I have never looked it up. I would say the cubical contents of that building were some place in the neighborhood of 400,000 to 500,000 cubic feet. I had a builder there give me a report on it for insurance alone, this last year, and he gave me a valuation as of 1933 of $21,000. The frontage is 60 feet on one street and 70 feet on another: that is on the corner of North and Central Streets in Lima. That is not the business district; it is more of a wholesale district. The lot is worth not to exceed $9,000. My estimate of $30,000 for the building, in 1930, was predicated approximately $10,000 for the lot and $20,000 for the building. It was a four story building, the full size of the lot, built of brick, and from twelve to fifteen years old. It would carry about 50 pounds per square foot—very light construction.

I said the Smith building in Canton was worth $7,500 at the time we bought it. It is a narrow two story building, a store room on the

first floor, and a five-room flat above. It is possibly 25 by 60 feet in depth. It was in horrible condition. It had been used and occupied by the bootlegger king of Canton. I do not know what he
22 paid as rental for it. He was supposed to own it, and the foreclosure was against this Smith, the bootlegger.

I did not inspect all of these buildings at the time the loans were made by the Midland. I inspected the Dalk property, but not the Smith property. The lease was made on that Dalk property in 1923. They loaned approximately $30,000 on it at that time. I do not know whether any of the principal was paid on it. Owing to my connection with the Insurance Company, I have rather make a study of cities and conditions, and Lima, commencing with the fall of 1925–1926, was one of the first towns to feel the slump, and we made no loans in Lima from at least 1927 on, on account of that.

I said the Ransom property in Detroit was worth $15,000 in 1929 or 1930. I do not know what the amount of the loan was in 1930. The Ransom property was located at 605 Atkinson Avenue, the corner of two boulevards, which is about one and one-half miles north of Grand Boulevard, where the Fisher Building is. There is a terrible lot of traffic there. It is a very old house; brick, the first story, and shingles, the second. Unfortunately, it is restricted to single residences only, and with the immense amount of traffic of two boulevards, with the trend to the outlying districts, the property was worth no more than $15,000 in 1929 or 1930.

The Harrington property in Detroit is an apartment house, located on what is known as West Grand Boulevard. It is approximately three miles from the center of downtown and is on what was known as the lower or worst section of the West Grand Boulevard. It was a brick building consisting of eleven two-room apartments, seven three-room apartments, and was in rather a deplorable condition. In Michigan they have one year to redeem the property. During that year they do not pay anything, taxes, water rent, or anything, and the Insurance Company had to pay—I can't tell you how much money—to put it in shape. The amount of the value was $37,500. I do not know how long it ran. If you were to tell me there was out on this property a principal at that time of foreclosure of $34,200, I would not think that would be a fair amount for loans on that property. I would have been willing to have loaned on that property on the basis that it was worth $37,500. I did not know what the principal was. I inspected the property sometime in 1928 and again in 1929. I do not believe I ever saw Exhibit A, a photostat sheet attached to the petition in this case, describing these loans. It was not prepared under my supervision.

23 Mr. CARNDUFF. That is all.

The MEMBER. Is there any redirect?

Mr. WRIGHT. No, sir.

The MEMBER. You are excused.

Mr. WRIGHT. Petitioner rests.

The MEMBER. Has respondent any further evidence to offer?

Mr. CARNDUFF. Respondent rests, and at this time moves for judgment on the evidence.

The MEMBER. The motion will be taken under advisement.

Approved and ordered filed this 27th day of Dec., 1934.

(s) LOGAN MORRIS,
Member.

Before United States Board of Tax Appeals

Praecipe for transcript of record

Filed Dec. 3, 1934

To the Clerk:

Please prepare transcript of the record in the above entitled cause for transmission to the United States Circuit Court of Appeals for the Sixth Circuit for review. In making up such transcript please deliver to for the purpose of printing, the following pleadings and documents in said cause, to wit:

1. The docket entries of proceedings before the Board.
2. Pleadings before the Board.
3. Memorandum opinion, and decision of the Board.
4. Petition for review.
5. The statement of evidence.

(s) FRANCIS J. WRIGHT,
(s) EARL F. MORRIS,
Attorneys for Petitioner.

24 [Clerk's certificate to foregoing transcript omitted in printing.]

25 In United States Circuit Court of Appeals for the Sixth Circuit

Minute entry

Cause Argued and Submitted April 9, 1936

Before MOORMAN, HICKS, AND SIMONS, JJ.

This cause is argued by Earl F. Morris and Edward W. Merkel for Petitioner and by Helen Carloss for Respondent and is submitted to the Court.

In United States Circuit Court of Appeals

Decree

Filed May 6, 1936

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged, and decreed by this Court that the order or decree of the said Board of Tax Appeals in this cause be, and the same is, hereby reversed and remanded for further proceedings, consistent with the opinion of this Court.

26 [Omitted.]

27 [File endorsement omitted.]

In United States Circuit Court of Appeals, Sixth Circuit

No. 7001

THE MIDLAND MUTUAL LIFE INSURANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition to review decision of United States Board of Tax Appeals

Opinion

Filed May 6, 1936

Before MOORMAN, HICKS, and SIMONS, Circuit Judges

SIMONS, Circuit Judge: The sole question involved in this review is whether accrued interest on defaulted loans secured by mortgages constitutes taxable income to the mortgagee by virtue of its having bid in the properties at foreclosure sales for the debts and interest, when the fair market value of the properties was less than the bids. The respondent made a determination of a deficiency in the petitioner's computation of net taxable income for 1930 by adding to such net income the accrued interest on certain mortgage loans in that year foreclosed. The Board of Tax Appeals sustained the determination nothwithstanding undisputed evidence that fair value was less than the total of the debt including interest.

The petitioner is a life insurance company, and kept its books on a calendar year cash basis. Only those payments of interest which were actually received were entered thereon. In 1930 it foreclosed certain Michigan and Ohio mortgages, and at the sales bid in the various parcels for amounts equalling the principal of the

28 loans plus the accrued interest. Its purpose in so doing was to secure itself against loss in the event of redemption, the local law in each case making provision for such redemption by the mortgage debtor. Upon receipt of title to mortgaged property the petitioner transferred the investment on its books from the mortgage loan account to the real estate account, and carried it upon its books in an amount equalling the principal of the loan, plus cost of fore-

closure, but exclusive of interest. No unpaid interest was carried as an asset either in the petitioner's annual statement or in reports to insurance departments. The bids in respect to the real estate here involved were made without regard to the actual value of the property, and at each sale the petitioner was the only bidder.

The deficiencies were asserted by the respondent, determined by the Board, and are now supported upon review on the ground that a bid at foreclosure sale by the mortgagee establishes the market for the particular property sold and is determinative as to receipt of income by the mortgagee. This is because the legal effect of such sale is said to be the same as though the mortgagee paid the full amount of its bid in cash and then received in cash the full amount of its debt, so that interest is received by it in cash or its equivalent. This view is supported not only by prior decisions of the Board, but by the Court of Claims in National Life Insurance Co. v. United States, 4 Fed. Supp. 1000, certiorari denied Lucey v. United States, 291 U. S. 683, and by the Court of Appeals of the Eighth Circuit in Missouri State Life Insurance Co. v. Helvering, Commissioner, 78 Fed. (2d) 778.

With profound deference to the courts which have considered the problem, we are unable to accept their reasoning. Whatever may be the legal effect of a foreclosure sale upon the passing of title and the extinguishment of the mortgage debt, the fact indisputably remains that when the mortgagee buys in the property he does not pay cash. The law permits him to set off the debt against the obligation created by his bid. This distinction is vital in determining whether he has received income. Without possessing the debt the mortgagee would not bid. He is primarily a lender and a purchaser only through necessity. To say that he pays cash and receives cash is to fly in the face of the realities. A mortgage lien upon property of a defaulting mortgagor is generally worth no more than the fair value of the security. It is true that the law invests it with the virtue of
29 currency, but only for a limited and definite purpose—the purchase of the mortgaged property. We are unable to see by what alchemy this baser metal is transmuted into gold through the mere formalities of a foreclosure sale.

Income has been defined as "The gain derived from capital, from labor, or from both combined." Stratton's Independence v. Howbert, 231 U. S. 399, 415; Doyle v. Mitchell Bros. Co., 247 U. S. 179, 185. Approved and analyzed was this definition in Eisner v. Macomber, 252 U. S. 189, 207. "Here," said the court, "we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property. Nothing else answers the description." It is said on be-

half of the respondent that by bidding the full amount of its debt the mortgagee secured protection against the mortgagor's redemption; that having acquired a benefit it should pay the tax regardless of the value of the property. But a benefit is not necessarily income. That need not be demonstrated. Here it is clearly not a gain derived from capital, or received or drawn by the taxpayer for its separate use, benefit and disposal. The property may be redeemed. In that event income is derived to the extent of interest included in the redemption price. Then interest is paid, and likewise received. But the property may not be redeemed. Is the realization in the one case no more in respect to the creation of income than mere expectation in the other? We think to put the query is to answer it. As was further said in Eisner v. Macomber, "It becomes essential to distinguish between what is and what is not income . . . ; and to apply the distinction, as cases arise, according to truth and substance, without regard to form."

There is urged upon us the existence of a presumption that at foreclosure sales the bid price is the fair market value of the property. Whether so or not, and this we do not decide, certainly the presumption by all familiar rules must disappear in the face of unchallenged and uncontroverted evidence that the fair value of the property is less. We know neither reason nor authority for such presumption being given conclusive effect. If so foreclosure sales could never be set aside for inadequacy of price, however gross or shocking to the conscience such inadequacy might be.

30 The court in Helvering v. Missouri State Life Insurance Co., supra, made a distinction between surrender of mortgaged real estate by the mortgagor to the mortgagee and the purchase of the property by the mortgagee under foreclosure. It concluded that a transaction of the first kind produces no income by way of interest to the mortgagee, while one of the latter does. We are unable to grasp the principle which distinguishes them, and we think the differentiation will not withstand analysis. Where the defaulting mortgagor surrenders the mortgaged property in extinguishment of the debt, the mortgagee acquires as against him a clear title. Where the mortgagee buys the property at foreclosure, he does not get clear title, but one still encumbered by the mortgagor's right to redeem. It seems to us anomalous to hold that one who receives less derives income, while one who receives more derives none. Demonstrating its conclusion that the recipient of the surrendered mortgage derives no income from accrued interest, the court says: "If the rule were otherwise, a life insurance company, all of the loans of which were in default and which was obliged to take over from its mortgagors mortgaged lands of little value in order to save the expense and delay of foreclosure, would be in the same situation with respect to interest received as though all of its loans were good and the interest had been paid in cash." We fail to see in what better situation is a life insurance company which not only is obliged to take over from its mort-

gageors lands of little value, but is in addition subjected to the expense and delay of foreclosure. If the illustration is persuasive in the one case, we are unable to see how it can be any less so in the other.

The theory of constructive receipt of income is not here applicable.

The decision of the Board is reversed. Conceiving it to be immaterial, the Board made no finding of fair value in respect to the foreclosed properties. Proper disposition therefore requires that the cause be remanded for further proceedings consistent herewith.

31 [Clerk's Certificate to foregoing transcript omitted in printing.]

32 Supreme Court of the United States

Order allowing certiorari. Filed October 12, 1936

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(Endorsement on cover:) File No. 40,797. U. S. Circuit Court of Appeals, Sixth Circuit. Term No. 257. Guy T. Helvering, Commissioner of Internal Revenue, petitioner vs. The Midland Mutual Life Insurance Company. Petition for a writ of certiorari and exhibit thereto. Filed August 4, 1936. Term No. 257 O. T. 1936.

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In the Supreme Court of the United States

OCTOBER TERM, 1936

No. ——

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE MIDLAND MUTUAL LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Sixth Circuit entered in the above-entitled cause on May 6, 1936.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 11–14) is unreported. The opinion of the Circuit Court of Appeals is reported in 83 F. (2d) 629.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 6, 1936. The jurisdiction of this

Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether accrued interest on loans secured by mortgages constitutes taxable income to the mortgagee when the mortgagee acquires title to the mortgaged properties upon foreclosure by bidding them in at the foreclosure sales for an amount equal to the loans and accrued interest.

STATUTE INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 201. TAX ON LIFE INSURANCE COMPANIES.

* * * * *

(b) *Rate of tax.* In lieu of the tax imposed by section 13, there shall be levied, collected, and paid for each taxable year upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, 12 per centum of its net income;

* * * * *

SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.

(a) In the case of a life insurance company the term "gross income" means the gross income received during the taxable gross amount of income received during the taxable year from interest, dividends, and rents.

STATEMENT

The stipulation of facts (R. 16–18) was adopted by the Board of Tax Appeals as its findings of fact (R. 11–13), and is as follows:

The respondent is an Ohio corporation and has its principal place of business at Columbus, Ohio. During the year 1930 there was due the respondent upon loans secured by real-estate mortgages in Michigan and Ohio, interest in the amount of $5,456.99. As these loans were in default in that year, the respondent foreclosed its mortgages and at the foreclosure sales, bid in the various pieces of real estate for amounts equaling the principal of the loans, plus the interest thereon.

Upon receipt of the title to such property, the respondent transferred the investments on its books from the mortgage-loan account to the real-estate account and carried such assets at amounts equaling the principal of the loans plus any disbursements which it had made for taxes, court costs, attorney fees, or insurance premiums for the preservation of the property, but the amounts of interest included in the bid at the foreclosure sales were not entered upon the books as a part of the cost of the properties or as an asset of the respondent. Nor did the respondent include such interest as an asset in its annual statement or convention report for the year 1930. Its books have been kept on a calendar year, cash basis.

The instructions issued to the respondent's representatives who have charge of the foreclosure of mortgages, in States where a period of redemption is allowed, are to bid at the sale under such foreclosure proceedings in behalf of the respondent such sum as will enable the respondent to realize no loss on account of its investment in case a redemption should be made from the foreclosure sale. Bids by the respondent's representatives have been made in accordance with these instructions, and the States in which the real estate here involved is located have laws allowing a period for redemption. The bids in respect of this real estate were made without regard to the actual value of the property, and the respondent was the only bidder at the foreclosure sales.

The Commissioner determined that the sum of $5,456.99 was taxable income to the respondent and should be included in its return for the year 1930. The Board approved this determination (R. 14). The Circuit Court of Appeals reversed the Board's decision (R. 25).

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the respondent did not realize taxable income, in an amount equal to the accrued interest on certain loans which it held and which were secured by mortgages, when it bid in the mortgaged properties at the foreclosure sales for an amount equal to the loans and accrued interest.

2. The Circuit Court of Appeals erred in reversing the decision of the Board.

REASONS FOR GRANTING THE WRIT

1. The decision of the court below presents a direct conflict with the decisions in *Helvering* v. *Missouri State Life Ins. Co.*, 78 F. (2d) 778 (C. C. A. 8th), and *National Life Ins. Co.* v. *United States*, 4 F. Supp. 1000 (C. Cls.), certiorari denied, *sub nom., Lucey* v. *United States*, 291 U. S. 683. In those cases the facts were exactly like the facts here, and it was held by both courts that the amount of accrued interest included in the bid price constituted taxable income. The same conclusion has been reached by the Board of Tax Appeals in cases involving the question raised here. See *Manomet Cranberry Co.* v. *Commissioner*, 1 B. T. A. 706, 709; *Reserve Loan Life Insurance Co.* v. *Commissioner*, 18 B. T. A. 359, 370; *MacLennan* v. *Commissioner*, 20 B. T. A. 900.

2. The decision of the court below holding that no taxable income was received by the respondent is believed to be unsound. The transactions here involved were actual purchases and sales. The respondent, as mortgagee, had instituted foreclosure proceedings against the mortgagors, and, to satisfy the judgments obtained, public sales were held. At such sales the respondent's representatives bid amounts equaling the principal of the loans and interest. The bids could, of course, have equaled only the amount of the loans, but interest

was included because the respondent sought protection for itself in the event the mortgagors attempted to secure the property during the period of redemption.

The bidding in of the mortgaged properties by the respondent's representatives placed a valid and binding liability on the respondent for the entire amount of the prices bid. As a general rule an officer selling property under a foreclosure decree has no authority to sell on credit or to accept anything in payment other than lawful money, but as the respondent held claims for principal and interest against the mortgagors, it was allowed to offset such claims against the amounts it had bid. In each instance the bids equaled the claims so the result was that the respondent's claims were satisfied and the mortgagors' obligation to pay interest as well as principal was entirely extinguished.

The respondent then took title to the several pieces of property, not as mortgagee, but as purchaser and in exactly the same manner as a stranger would have, had he bid in the property. In other words, as the court stated in the case of *National Life Ins. Co., supra* (p. 1012), the transactions were no different in effect than if the respondent had paid the full amount of its bids in cash to the officers making the sales, and such officers had thereafter returned the money to the respondent in payment of the unpaid principal and interest. It is immaterial that the market values

may have been less than the prices bid. For purposes of these transactions the bids established the market. By offsetting its liability against its claims the respondent realized income to the extent of the accrued interest and is subject to tax on such amount.

3. The question here is one of importance, particularly in those States where the mortgagor has an equity of redemption, and bids including principal and interest are made with the local law in view.

Wherefore it is respectfully submitted that this petition should be granted.

STANLEY REED,
Solicitor General.

AUGUST 1936.

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In the Supreme Court of the United States

OCTOBER TERM, 1936

No. 257

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE MIDLAND MUTUAL LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 8–11), is unreported. The opinion of the Circuit Court of Appeals (R. 18–22) is reported in 83 F. (2d) 629.

JURISDICTION

The decree of the Circuit Court of Appeals was entered May 6, 1936. (R. 18.) The petition for writ of certiorari was filed August 4, 1936, and was granted October 12, 1936. (R. 22.) The

jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether accrued interest on loans secured by mortgages constitutes taxable income to the mortgagee when the mortgagee acquires title to the mortgaged properties upon foreclosure by bidding them in at the foreclosure sales for an amount equal to the loans and accrued interest.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations involved will be found in the Appendix, *infra*, pp. 21–23.

STATEMENT

The stipulation of facts (R. 12–14) was adopted by the Board of Tax Appeals as its findings of fact (R. 8–11) and is as follows:

The respondent is an Ohio corporation and has its principal place of business at Columbus, Ohio. During the year 1930 there was due the respondent upon loans secured by real estate mortgages in Michigan and Ohio, interest in the amount of $5,456.99. As these loans were in default in that year, the respondent foreclosed its mortgages and at the foreclosure sales bid in the various pieces of real estate for amounts equaling the principal of the loans, plus the interest thereon.

Upon receipt of the title to such properties, the respondent transferred the investments on its

books from the mortgage-loan account to the real estate account and carried such assets at amounts equaling the principal of the loans plus any disbursements which it had made for taxes, court costs, attorney fees or insurance premiums for the preservation of the properties, but the amounts of interest included in the bid at the foreclosure sales were not entered upon the books as a part of the cost of the properties or as an asset of the respondent. Nor did the respondent include such interest as an asset in its annual statement or convention report for the year 1930. Its books have been kept on a calendar year, cash basis.

The instructions issued to the respondent's representatives who have charge of the foreclosure of mortgages, in States where a period of redemption is allowed, are to bid at the sale under such foreclosure proceedings in behalf of the respondent such sum as will enable the respondent to realize no loss on account of its investment in case a redemption should be made from the foreclosure sale. Bids by the respondent's representatives were made in accordance with these instructions, and the States in which the real estate here involved is located have laws allowing a period for redemption. The bids in respect of this real estate were made without regard to the actual value of the property, and the respondent was the only bidder at the foreclosure sales.

The properties which were acquired in these foreclosure proceedings, with the dates thereof and the

amounts bid by the respondent, are as follows (R. 10):

Location	Petitioner's Mortgage Loan Number and Name of Mortgages	Date of Bid	Date of Acquisition of Title	Amount of Bid
Detroit, Mich.	931—Caruso	Jan. 15, 1929	Jan. 15, 1930	$10,192.08
" "	1350—Ransom	July 22, 1929	July 22, 1930	16,525.88
" "	1326—Hallam	Aug. 6, 1929	Aug. 6, 1930	18,127.03
" "	1170—Harrington	Oct. 19, 1929	Oct. 19, 1930	39,251.57
Canton, Ohio	1093—Smith about	Mch. 19, 1930	Mch. 24, 1930	10,351.65
Lima, Ohio	623—Dalk "	Nov. 29, 1930	Dec. 2, 1930	33,334.00

The Commissioner determined that the sum of $5,456.99, representing accrued interest, was taxable income to the respondent and should be included in its return for the year 1930. The Board approved this determination. (R. 11.)

Before the Board, the respondent introduced the testimony of one witness who gave his opinion of the fair market value of the several pieces of real estate involved herein both at the time of foreclosure and the date of acquisition of title by the respondent. With respect to each property the amount testified to as of the different dates was less than the bid of the respondent. (R. 14–18.)

Conceiving it to be immaterial, the Board made no finding of fair value with respect to the foreclosed properties except to say that the fair market values were less than the amount of the loans upon such properties, plus accrued interest. (R. 11.) The Circuit Court of Appeals reversed the Board's decision and remanded the case for further proceedings consistent with its opinion. (R. 18–19.)

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the respondent did not realize taxable income in an amount equal to the accrued interest on certain loans which it held and which were secured by mortgages, when it bid in the mortgaged properties at the foreclosure sales for an amount equal to the loans and accrued interest.

2. The Circuit Court of Appeals erred in reversing the decision of the Board.

SUMMARY OF ARGUMENT

When mortgaged property is sold on foreclosure for an amount sufficient to pay the mortgage debt with accrued interest, the mortgagee has received payment in full of its debt, and that is so, regardless of whether the highest bidder at the sale is the mortgagee or a stranger.

In the instant case the respondent life insurance company bid in mortgaged properties, at public sales, for the full amount of the unpaid principal and accrued interest. It thus acquired the properties as a purchaser and established their values in sums equivalent to the unpaid principal and interest due thereon. The interest included in the value of the property, received and applied in the extinguishment of its total debt, is income to the respondent in the year the title is acquired to the property, under Section 202 (a), Revenue Act of 1928, *infra*. It is immaterial that the so-called fair market value of the foreclosed properties to

others is less than the price which the taxpayer-mortgagee is willing to pay.

If the fair market value of the property be material, it is quite plain the taxpayer received property of a value equal to the unpaid principal and accrued interest. The property being something of exchangeable value, equivalent to a cash payment, the treatment of the receipt of such property as the receipt of interest is in accordance with this Court's definition of income.

ARGUMENT

PRELIMINARY STATEMENT

Prior to the enactment of the Revenue Act of 1921, c. 136, 42 Stat. 227, life insurance companies were taxable as ordinary corporations and were required to include in gross income not only their investment and underwriting income, but also their gains from the sale of capital assets. When the Revenue Bill of 1918 was before the Senate of the United States for consideration, the Association of Life Insurance Presidents sought and obtained from the Senate an amendment giving to life insurance companies special treatment.[1] The Senate amendment to the House bill, however, was not approved by the House, and life insurance companies, under the Revenue Act of 1918, c. 18,

[1] Hearings before the Senate Committee on Finance, on H. R. 8245, 67th Cong., 1st Sess., p. 84, September 1–October 1, 1921. See also S. Rep. No. 275, 67th Cong., 1st Sess., p. 20.

40 Stat. 1057, were still taxable as ordinary corporations.

Subsequently, however, when the Revenue Bill of 1921 was under consideration, both the life insurance companies and insurance companies other than life or mutual, renewed their efforts, because of the peculiar nature of their business, to obtain a special classification for purposes of Federal taxation, and in this these companies were successful, with the result that since the enactment of the Revenue Act of 1921 the gross income of such insurance companies and the deductions permitted them are substantially different from those of ordinary corporations. Thus, life insurance companies are, by Sections 201 to 203, inclusive, of the Revenue Act of 1928 (reenacting the corresponding provisions of the Revenue Acts of 1921, 1924 and 1926), as well as the corresponding provisions of the Revenue Acts of 1932 and 1934, segregated for tax purposes from other corporations, the gross income of such companies consisting solely of interest, dividends, and rents received during the tax year. "Underwriting income," under the Revenue Acts of 1921 and subsequent Revenue Acts, is not included in the gross income of a life insurance company, nor are gains upon the sale of capital assets recognized. Again, the deductions permitted to life insurance companies under the provisions of Section 203 of the Revenue Act of 1928, as might be expected, differ materially from those allowed ordinary corporations, and the deductions allowed

do not include losses on the sale of capital assets. That the Revenue Act of 1921 brought about a material change in computing the net income of life insurance companies has been recognized by this Court in the case of *New York Life Ins. Co.* v. *Bowers,* 283 U. S. 242, 248. See also dissenting opinion of Mr. Justice Brandeis in the case of *Nat'l Life Ins. Co.* v. *United States,* 277 U. S. 508, 523; *Massachusetts Mut. Life Ins. Co.* v. *United States,* 56 F. (2d) 897 (C. Cls.).

With this background, we come now to consider the single issue presented on this writ of certiorari.

THE AMOUNT OF INTEREST OWED TO THE RESPONDENT AND INCLUDED IN THE PURCHASE PRICE OF MORTGAGED PROPERTIES SOLD UPON FORECLOSURE PROCEEDINGS TO THE RESPONDENT CONSTITUTES TAXABLE INCOME

During 1930, the respondent acquired title to several pieces of property in Ohio and Michigan upon which it held mortgages and which it purchased at foreclosure sales. As the purchase price included in each instance the accrued interest in addition to the unpaid principal, the Board of Tax Appeals held that the amount of such interest constituted taxable income. The decision of the Board is in accordance with its rule long adhered to and applied in a number of other cases in which it passed on the issue presented here. See *Manomet Cranberry Co.* v. *Commissioner,* 1 B. T. A.

706, 709; *Reserve Loan Life Insurance Co.* v. *Commissioner,* 18 B. T. A. 359, 370; *Mac Lennan* v. *Commissioner,* 20 B. T. A. 900; *Missouri State Life Insurance Co.* v. *Commissioner,* 29 B. T. A. 401, affirmed, 78 F. (2d) 778 (C. C. A. 8th); *American Central Life Insurance Co.* v. *Commissioner,* 30 B. T. A. 1182.

In the instant case, however, the Sixth Circuit Court of Appeals declined to follow the rule adopted by the Board and also applied by the two other courts which have passed on this question. See *National Life Ins. Co.* v. *United States,* 4 Fed. Supp. 1000 (C. Cls.), certiorari denied, *sub nom. Lucey* v. *United States,* 291 U. S. 683; *Missouri State Life Insurance Co.* v. *Commissioner, supra.* The court below recognized that its decision was directly in conflict with the two just cited cases but refused to accept the reasoning of the courts in those two cases. It squarely held that neither in legal effect, nor in fact, did the respondent receive interest by the acquisition of the mortgaged properties at foreclosure sales on its own bids in amounts equal to the principal and unpaid interest.

The theory upon which the Commissioner has long included in gross income of life insurance companies accrued interest in such cases is probably best stated in the opinion of the Court of Claims in the *National Life Ins. Company* case, *supra.* In that case, as in this, the taxpayer had outstanding a number of mortgage loans on which

there had been default and, as here, it caused the mortgages to be foreclosed and the properties involved to be sold at public foreclosure sales. The taxpayer was the only bidder and in those States where the state law provided that the property might be redeemed by the mortgagor or junior lienholders, it bid the full amount of the unpaid principal and accrued interest due thereon up to the date of the sale, together with court costs and other charges. It was the taxpayer's contention that, under the language of the statute and regulations, the accrued interest in default did not constitute income received when the mortgaged properties were acquired because none of the interest was actually received during the taxable years, but the court did not agree. While the court admitted that the income of a life insurance company, under the statute, is to be computed on the basis of actual receipts and disbursements, it held that the interest had been received when the properties were acquired, and constituted taxable income. The court said (p. 1011):

> In its essence the transaction consisted of a judgment in favor of plaintiff and against the mortgagor for the principal indebtedness plus the accrued interest and a decree of foreclosure and sale of the properties given as security for such indebtedness and interest. * * * At these public sales plaintiff offered for the properties the full amount of the unpaid principal and accrued interest due it to the date of the sale, and the prop-

> erties were duly sold to plaintiff by the officer designated by the court to make the sale. This, in our opinion, established the market for these particular properties for the purposes of this case and is determinative of whether plaintiff received the interest in question.
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> * * * * *
>
> Viewed in this light plaintiff actually received the interest due it. Inasmuch, however, as plaintiff was the purchaser of the properties under the sales there was no payment of money but the properties were deeded to plaintiff. There must have been, and doubtless were, circumstances which led plaintiff to believe that the acquisition of a complete and clear title to the properties was worth the amount of the unpaid principal and accrued interest to it. There was a consideration moving to plaintiff for its bid for the amount of the unpaid principal and accrued interest; such bid foreclosed the equity of redemption of the mortgagor or junior lienholder and precluded all further controversies that might have arisen had the property been bid in for a lesser sum and judgment taken against the mortgagor for the balance.

Likewise, the Eighth Circuit Court of Appeals, in *Helvering* v. *Missouri State Life Ins. Co., supra*, in passing upon precisely the same question, held (p. 780):

> When mortgaged property is sold on foreclosure for an amount sufficient to pay the

mortgage debt with accrued interest, the mortgagee has received payment in full of its debt, and that is so, regardless of whether the highest bidder at the sale is the mortgagee or a stranger. Where a stranger buys, he pays cash to the officer making the sale, who pays it to the mortgagee. Where the mortgagee buys the property, instead of paying cash to the officer and receiving it back, he credits the amount which he, as purchaser, bids, upon the mortgage debt. In either event, he receives payment in cash or its full equivalent.

In the case at bar, the respondent and the court below relied largely upon the fact that the so-called "fair market value" of the properties in this case was less at the time of acquisition than the unpaid principal of the loans. In this connection, it should be noted that it was the respondent here which set the amount of the bids and made the bids large enough to include accrued interest, as well as unpaid principal. It did this as a protection to itself in case the mortgagor attempted to secure the property during the period of redemption. In other words, it secured a benefit by fixing the purchase price at these sales. Accordingly, having served its own purposes, it should not now be allowed to escape the burden which follows such action but should be required to pay the tax on the interest which it included in the purchase price, regardless of what might be said to be the "fair market value" of these properties to others.

We are of this opinion because it is not open to question that a valid, binding, and enforceable liability for the bid price is created as soon as mortgaged property is struck off to a successful bidder at the foreclosure sale. Likewise, the respondent in this case incurred by its bid an enforceable liability equal to the price which it offered when the respective mortgaged properties were knocked down to it by the sheriff or other officer conducting the sale. *National Life Ins. Co.* v. *United States, supra; Strother* v. *Wilkinson,* 108 Okla. 57; *Andrews* v. *O'Mahoney,* 112 N. Y. 567.

As a general rule, an officer selling property under a decree of foreclosure has no authority to sell or credit or to accept as payment on bid prices anything other than lawful money, unless otherwise expressly authorized by the terms of the decree or the law in force governing the sale. Where the creditor becomes purchaser of the mortgaged property, it is usually considered a sufficient compliance with the requirements of a sale for cash that the amount of the bid be credited on the mortgage debt and the judgment for the indebtedness is fully satisfied to the extent of the amount paid by the creditor. Freeman on Judgments, 5th Ed., Vol. 2, p. 2371; *Walker* v. *Powers,* 104 U. S. 245; *Lockwood* v. *Cook,* 58 Neb. 302.

When the respondent bid in the mortgaged property, it became a purchaser and its title and rights in, and to, such properties were precisely the same

as if it had been a stranger to the mortgages. The fact that the respondent was not only the purchaser but also the mortgagee is without legal significance. The mortgagee acquires the same right and interest in the property sold as any other person would, no more, no less. The only advantage the mortgagee has is that to the amount of the judgment in its favor it is not obligated to make actual payment of the purchase price, for to that extent its bid is payment on its debt. *Ledyard* v. *Phillips,* 47 Mich. 305; *Avon-by-the-Sea Land & Improvement Co.* v. *Finn,* 56 N. J. Eq. 808; cf. *Baird* v. *Northern Savings Bank,* 56 N. D. 811

Accordingly, on the acquisition of these properties, the respondent here entered into possession thereof, not as a mortgagee but as a purchaser. *Belter* v. *Lyon,* 102 N. Y. 725, 7 N. E. 821. It paid either cash or the equivalent of cash by crediting the amount of its bids against the mortgagor's indebtedness, thereby releasing and extinguishing the latter's liability to the extent of the proceeds of the foreclosure sales applicable to the mortgage debts. Such transactions were no different than if the respondent had paid to the officers making the sales the full amounts of its bids and such officers had thereafter returned the money to the respondent in payment of the unpaid principal and accrued interest. In legal effect, this is the result of the transactions by which the respondent acquired title here, and to the extent of the accrued interest the respondent realized taxable income.

The fact that the accrued interest was not entered on the books of the respondent as income is not material because it is well established that bookkeeping entries are not conclusive. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71. Bookkeeping records alone will not justify a taxpayer in claiming an exemption. It is the real facts and not such records which must control in determining net income. *Southern Pacific R. Co.* v. *Muenter*, 260 Fed. 837 (C. C. A. 9th); *Chattanooga Sav. Bank* v. *Brewer*, 9 F. (2d) 982 (E. D. Tenn.).

Also the possibility that a mortgagee, who becomes the purchaser of mortgaged property by bidding it in for the amount of the principal and accrued interest, may sustain a loss on a future disposition of the property is of no controlling importance in determining whether such mortgagee received such interest as taxable income. The future disposition of the property is necessarily an entirely different transaction. Moreover, while a loss cannot be deducted by a life insurance company, it is also true that any profit which might be made on a future sale cannot be treated as interest on the loan, and is not even taxable, and inasmuch as it cannot be classified as interest, dividends, or rent, it does not come within the statutory provision describing taxable income for life insurance companies. See Section 202, Revenue Act of 1928, and Article 961, Regulations 74, *infra*.

So, we submit, it is immaterial that the fair market value of the properties acquired by the respondent may have been less than the consideration which the taxpayer was willing to pay in order to acquire title to these properties. *National Life Ins. Co.* v. *United States, supra; Missouri State Life Insurance Co.* v. *Commissioner, supra.*

If the fair market value of the property be material, we think it quite plain that, under the circumstances here, the taxpayer has received something of exchangeable value, in an amount equal to the unpaid principal and accrued interest. This being true, the treatment of such property by the Commissioner as the equivalent of a cash payment is in accordance with the definition of income approved by this Court. *Eisner* v. *Macomber,* 252 U. S. 189. There, this Court held that income may be derived from "something of exchangeable value proceeding from the property" (p. 207). Here, we have properties acquired by the taxpayer at a value which included the accrued interest. As pointed out above, the bid in this amount was for the purpose of foreclosing the mortgagor from redeeming the property at any figure less than the principal of the debt plus accrued interest. The taxpayer, in thus protecting himself, fixed the amount which the mortgagor would be forced to pay in order to redeem the property. As between the parties the value of the property was set at a

figure which included interest. The taxpayer was unwilling, during the taxable period, that these properties should go to another at less than the amounts bid. This is the significant and controlling factor, we submit, which sets the "exchangeable value" of these properties at a figure which includes accrued interest and thus meets the accepted definition of taxable income. It is not material for present purposes, of course, that these properties may thereafter be sold at a net gain or loss to the taxpayer. The Federal revenue laws relating to income taxes are based upon an annual accounting period and the receipt of income is computed upon the net result of all transactions within the year. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359.

The court below was of the opinion that, because the taxpayer was the mortgagee and allowed to set off against the bid price the amount of his debt, the instant case is wholly different than if the respondent had received full cash payment. (R. 20.) We submit that this distinction is not vital when it is realized the taxpayer received, instead of cash, property of an equivalent value. To deny it such equivalent value is to disregard the actual fact, as shown by the taxpayer's voluntary bid at a public sale, that the property in question was worth, to the respondent, the full amount of its unpaid principal and accrued interest. Accordingly, it is submitted, the property received may properly, with-

out resort to the doctrine of constructive receipt, be treated as cash to the extent of its value, and the interest which the taxpayer is required to include in income is not restricted to cash receipts bearing the label of interest. *American Central Life Ins. Co.* v. *Commissioner*, *supra*, p. 1190.

Even in cases where the taxpayer itself has advanced funds for the payment of interest on obligations which it owns, the courts have held that the return thereof to the taxpayer constitutes taxable income. In *American Cigar Co.* v. *Commissioner*, 66 F. (2d) 425 (C. C. A. 2d), certiorari denied, 290 U. S. 699, interest on bonds was paid from funds advanced for that purpose by the taxpayer, a large stock and bond holder of the debtor corporation. The advances were made for operating expenses and the payment of interest upon the bonds, because the taxpayer corporation was reluctant to have the debtor placed in receivership. As here, the taxpayer was doing something to protect its own financial interests. The court held that although the interest received was from funds advanced by the taxpayer, that fact could not alter the character of the interest and its taxability as such. A like result was reached by the Circuit Court of Appeals for the Fourth Circuit in *Duke Power Co.* v. *Commissioner*, 44 F. (2d) 543, 545, certiorari denied, 282 U. S. 903, a case involving similar circumstances, because "Interest, by the very terms of the act, is made income, and is tax-

able." So, we submit, it is not necessary that interest received, to be taxable, must reflect a clear gain or profit on invested capital; but where, as here, property is received of the equivalent value of a cash payment of the interest, the statute requires that, to such extent, interest be included in the gross income of the recipient. See *Eisner* v. *Macomber, supra.*

If insurance companies are permitted to bid in mortgaged properties at amounts which will protect the accrued interest as well as the principal in case of redemption, to carry these properties on their books at figures which do not reflect the receipt of such interest, and in later years to sell the properties for enough or more than enough to offset both unpaid principal and accrued interest, an avenue is open for the escape in substantial amounts of one of the principal sources of their taxable income. This is true because the statute taxes only interest received during the taxable year and at no time taxes the gain upon capital assets. We submit that Congress, having already provided for special and privileged treatment of the taxable income of life insurance companies, different from that of other corporations and individuals, never intended that property bid in or purchased by an insurance company at one value should be accorded another and lower value for income tax purposes.

CONCLUSION

In view of the foregoing, we respectfully submit that the decision of the Circuit Court of Appeals should be reversed.

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DAVID E. HUDSON,
SEWALL KEY,
MAURICE J. MAHONEY,
Special Assistants to the Attorney General.

NOVEMBER 1936.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 201. TAX ON LIFE INSURANCE COMPANIES.

* * * * *

(b) *Rate of tax.*—In lieu of the tax imposed by section 13, there shall be levied, collected, and paid for each taxable year upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, 12 percentum of its net income;

* * * * *

SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.

(a) In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

* * * * *

Treasury Regulations 74:

ART. 193. *Uncollectible deficiency upon sale of mortgaged or pledged property.*—Where mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off,

he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. In addition, where the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

Accrued interest may be included as part of the deduction only when it has previously been returned as income.

ART. 951. *Life Insurance companies.*— Life insurance companies, as defined in section 201 (a), are subject to the tax imposed by section 201 (b), in lieu of the tax imposed by section 13. The rate for 1928 and for subsequent years is 12 per cent, and the net income upon which the tax is imposed differs from the net income of other corporations. Insurance companies are entitled to the benefit of section 117 (net losses) but not of section 101 (capital gains and losses). All provisions of the Act and of these regulations not inconsistent with the specific

provisions of sections 201–203 are applicable to the assessment and collection of this tax, and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. In determining whether an insurance company is a "life insurance company" as defined in section 201, no reserve shall be regarded as held for the fulfillment of life insurance and annuity contracts unless the company is entitled to a deduction from gross income on account thereof under the provisions of section 203 (a) (2) and article 971. As to foreign companies, see section 203 (c) and article 977.

ART. 961. *Gross income of life insurance companies.*—Gross income in the case of life insurance companies means the gross amount of income received from interest, dividends, and rents, and comprises items 25–34 of the income page of the annual statement for life insurance companies (edition of 1920) adopted by the National Convention of Insurance Commissioners and items 23–30 of the income page of the annual statement for miscellaneous stock companies if any other branches of the insurance business are conducted by the company; except that the rental value of the space occupied by the company in its own building or buildings if included in gross income shall be determined according to the provisions of section 203 (b) and article 976. As to "reserve funds required by law", see article 971.

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IN THE

Supreme Court of the United States

October Term 1936; No. 257.

GUY T. HELVERING, Commissioner, Etc., - - Petitioner,

versus

MIDLAND MUTUAL LIFE INSURANCE COMPANY.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

BRIEF FOR MIDLAND MUTUAL LIFE INSURANCE COMPANY.

A mortgagee does not receive any "income from interest," when, at a foreclosure sale, he "bids in" the property for his debt and interest, if the "fair value" of the property is less than the principal debt (exclusive of interest).

F. J. WRIGHT,
WM. MARSHALL BULLITT,
Counsel for Respondent.

WESTERFIELD-BONTE CO., INCORPORATED, LOUISVILLE, KY.

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[References Required by Rules 12 and 27.]

OPINION BELOW: *Midland Mutual Life* v. *Com'r*, 83 F. (2) 629.

JURISDICTIONAL AUTHORITY: Judicial Code, §240(a), as amended by Act of February 13, 1925.

STATUTES INVOLVED: Revenue Act of 1928, §202; 45 Stat. 791, 842.

DATE OF JUDGMENT, etc. May 6, 1936 (R. 19).

NATURE OF THE CASE, RULINGS, etc. The Commissioner determined a $654.84 deficiency tax against the Midland Mutual Life Ins. Co.

The B.T.A. held that where, at a foreclosure sale, a life insurance company "bid in" mortgaged property for an amount equal to the debt *and accrued interest*, such interest became taxable *interest-income, regardless of the "fair market value" of the property foreclosed.*

The C.C.A. (6th) *reversed* the B.T.A.; and held that where the "fair market value" of the foreclosed property was *less* than the principal debt, no interest-income was received by the mortgagee.

Certiorari was granted.

IN THE

Supreme Court of the United States

October Term 1936; No. 257.

GUY T. HELVERING, COMMISSIONER, ETC., *Petitioner,*

vs.

MIDLAND MUTUAL LIFE INSURANCE COMPANY.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

BRIEF FOR MIDLAND MUTUAL LIFE INSURANCE COMPANY.

The only question involved is whether $5,456.99 *past-due and uncollected* mortgage interest became *automatically transmuted* into $5,456.99 taxable *Interest-income* to a *life insurance* company, simply because, on foreclosing the mortgages, it "bid in" the property for the full amount of its debt and $5,456.99 of interest,* although the B.T.A. specifically found that the fair market value of the property was about $9,000 *less* than the principal debt—to say nothing of the interest.

Did such a protective "buying in" of property (not worth the debt) *ipso facto* constitute, for purposes of *life insurance* taxation, *a receipt of the $5,456.99 past due interest?*

That is the question to be decided here.

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*There was actually $15,538.60 unpaid accrued interest due to the Midland Mutual on the foreclosed properties (R. 7); but as the Midland Mutual's "bid" at the foreclosure sale only included $5,456.99 for unpaid interest, the Commissioner assessed the deficiency tax only on account of $5,456.99 interest which he held should have been included in its taxable income.

The Midland Mutual further lost the $10,081.61 balance of unpaid accrued interest; and it could not even "charge off" that part of the loss in any way, as neither the "bad debt," nor the capital "gain" and "loss," provisions of the Revenue Acts apply to *life insurance* companies.

STATEMENT OF THE FACTS.

1. *The foreclosure suits.* The Midland Mutual is a life insurance company which kept its books on a strictly "calendar-year" "cash receipt and disbursement" basis. It never entered any interest payments on its books or records until they were "actually made to and received by" it (R. 13).

In 1930, it foreclosed six long-defaulted mortgages on Ohio and Michigan real estate. It was the only bidder at the judicial sales. It bid such amounts as would enable it "to realize no loss on account of its investment *in case a redemption should be made from the foreclosure sale*"; and it "bid in" the property "without regard to the actual value, but with a view of protecting the investment in case of redemption," as follows (R. 7, 13-14):

Unpaid principal, plus taxes, court costs, attorneys fees, etc., *i. e.*, "Cost basis"	$123,423.57
Unpaid interest	5,456.99
Property "bid in" for	$128,880.56*
The B.T.A. specifically found that the "fair market values of the properties . . . at the dates acquired are" (p. 4, note, *infra*)	$114,500.00
Loss because the "fair market value" of the property was not worth the amount of its "bid," by the amount of	$14,380.56
Additional loss of unpaid accrued interest not even included in the "bid"	10,081.61
Actual loss to the Midland Mutual on the foreclosed properties	**$ 24,462.17**

*A small discrepancy between the correct "bid" prices given in the 60-day deficiency letter (on the basis of which the exact $5,456.99 interest item was determined, R. 4-7) and the "bid" prices erroneously stipulated (R. 14), is ignored in the Government's Brief; and we shall likewise ignore it.

In 1930, the property was conveyed to the Midland Mutual, but, as just shown, it was not worth anything like the amount of the principal debt, to say nothing of the unpaid interest due (R. 10, 11, 13-17; B.T.A.'s ADDITIONAL FINDINGS OF FACT, p. 4, note, *infra*).

2. *The Midland Mutual's treatment of the interest item.* After acquiring title, the Midland Mutual transferred its investment on its books "from the mortgage loan account to the real estate account"; and carried the property on its books as a real estate asset at an amount [$123,423.57] exactly equal to the *principal debt* only (excluding interest), to-wit;

> "the amount of interest [$5,456.99] included in the bid at said foreclosure sales *was not carried* upon the books . . . as a part of the cost of said properties or as an asset of this petitioner [Midland Mutual]. That is to say, the investments, on the books of the petitioner [Midland Mutual] in each of said properties so acquired included only the *unpaid principal* of the loan thereon and disbursements as aforesaid and *did not include the interest* upon said principal." (STIPULATION OF FACTS, R. 13.)

The Midland Mutual did not include the $5,456.99 interest item as an asset in its Annual Statement (Convention Report) for 1930; never entered it on its books or otherwise treated it as income (R. 13-14); and did not include it as "income received from interest" in its 1930 return.

Nevertheless, the Commissioner assessed a $654.84 deficiency tax, on the ground that the Midland Mutual

had received the $5,456.99 "from interest" in 1930, and should have included it as "gross income" in its 1930 return (R. 5).

3. *The decisions below.* The B.T.A. sustained the Commissioner on the authority of the Eighth Circuit case of *Missouri State Life Ins. Co.* v. *Helvering,* 29 B. T.A. 401, 78 F. (2d) 778 (C.C.A. 8th) [R. 8-11].

On appeal, the Sixth Circuit refused to follow the Eighth Circuit's decision in the *Missouri State Life* Case (R. 20); *reversed* the B.T.A. and held that the Midland Mutual did *not* receive $5,456.99 income "from interest" in 1930 (R. 19-22; 83 F. (2d) 629).

Certiorari was granted to solve the conflict in *reasoning* between the Sixth and Eighth Circuits, respectively (R. 22).

In point of fact, the Eighth Circuit did not actually conflict with the Sixth Circuit, because (1) the B.T.A. found that "the fair market values" of the Midland Mutual's properties were in each instance *less* than the unpaid principal, taxes, court costs, etc.,*

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*On October 7, 1936, the B.T.A. rendered a Supplemental Memorandum Opinion, and made "Additional Findings of Fact," in which it found

"The fair market values of the properties which were acquired in said foreclosure proceedings at the dates acquired are as follows; . . .

Mortgage Loan Number and Name of Mortgagor	Fair Market Value
931—Caruso	$ 8,500
1350—Ransom	15,000
1326—Hallam	16,000
1170—Harrington	37,500
1093—Smith	7,500
623—Dalk	30,000"
[Total "fair market values" of foreclosed properties	**$114,500]**

The values so found were, in each instance, *less* than the re-

whereas, on the other hand, (2) at the time of the Missouri State Life's acquisition of title (so far as the Eighth Circuit's opinion discloses) the property may have been worth *a great deal more* than the principal debt and accrued interest—in which event the interest may well be deemed to have been collected in full (p. 30, *infra*).

The same distinction exists in *National Life Ins. Co.* v. *U. S.*, 4 F. Supp. 1000 (Court of Claims) strongly relied on by the Government (pp. 27-28, *infra*).

The Method of Taxing the Income of Life Insurance Companies.*

Since 1921, the "gross income" of all life insurance companies has always been *strictly limited* to only three items, *i. e.*, Interest, Dividends and Rents (Revenue Act of 1928, 45 Stat. 791, 842)†:

"SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.

(a) In the case of a life insurance company the term 'gross income' means the gross amount of income **received during the taxable year from interest**, dividends and rents."

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spective unpaid principal mortgage debt, taxes, court costs, etc. (exclusive of all interest).

This Additional Finding of Fact required by the C.C.A.'s Opinion of reversal (R. 22) does not appear in the printed Record in this Court, because the B.T.A.'s Finding was made *after* the filing of the petition for *Certiorari*.

*See Appendix, p. 31; *infra*, for an explanation and historical review of the method of taxing the income of life insurance companies.

† §244(a) of the Revenue Acts of 1921 [42 Stat. 227, 261]; 1924 [43 Stat. 253, 289]; 1926 [44 Stat. 9, 47]; §202(a) of the Revenue Acts of 1928 [45 Stat. 791, 842]; 1932 [47 Stat. 169, 224]; 1934 [48 Stat. 680, 731]; 1936 [49 Stat. 1710].

No Regulations have ever been issued on the subject of interest received or realized in cases of mortgage foreclosures.

Beginning with Regulations 69 (issued under the Revenue Act of 1926) and in all Regulations issued under subsequent Revenue Acts,‡ an Article was inserted entitled

"Uncollectible deficiency upon sale of mortgaged or pledged property,"

which provided for (1) the charging off of such uncollectible *deficiency* as a "bad debt" and (2) capital "gains" or "losses" where the mortgagee bought in the mortgaged property upon foreclosure.

As none of the statutory provisions for either "bad debts" or capital "gains" and "losses" apply to *life insurance* companies (and have not applied to them since the passage of the Revenue Act of 1921), the identic Articles [Nos. 153, 193, 23(k)-3] in Regulations 69, 74, 77, 86 and 94 have no application whatever to life insurance companies (*National Life Ins. Co.* v. *U. S.*, 4 F. Supp. 1000, 1012).

Although the Article in question [Art. 193, Reg. 74] is copied in the Appendix to the Government's Brief, it is nowhere else referred to therein; and hence its provisions may be ignored as totally irrelevant to the present *life insurance* company case.

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‡See Reg. 69, Art. 153 (1926); Reg. 74, Art. 193 (1928); Reg. 77, Art. 193 (1932); Reg. 86, Art. 23(k)-3 (1934); Reg. 94, Art. 23(k)-3 (1936).

SUMMARY OF POINTS DISCUSSED.

1. **The fair market value of the property,* at the time the Midland Mutual acquired it, was only $114,500, which was about $9,000 less than the principal debt (exclusive of all interest)** (p. 8, *infra*).

2. **The Midland Mutual did not "receive", *in cash or in property*, the $5,456.99 accrued interest (or any part thereof); and, therefore, the $5,456.99 was not "gross income" under §202, Revenue Act of 1928** (pp. 9-11, *infra*).

3. **The Midland Mutual's $128,880.56 "bid" at the foreclosure sale did not conclusively establish that the fair value was $128,880.56. The fair value was only $114,500 as found by the B.T.A.** (pp. 12-26, *infra*).

4. **A review of the Government's authorities** (pp. 27-29, *infra*).

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*For grammatical convenience, the six properties and the aggregate "fair values" thereof, will sometimes be spoken of in the singular number, as if there were but one property.

FIRST POINT.

The fair market value of the property, at the time the Midland Mutual acquired it, was only $114,500, which was about $9,000 less than the principal debt (exclusive of all interest).

1. The B.T.A. made an express FINDING OF FACT (which was in exact accord with the uncontradicted testimony R. 15-17), that,

> "The **fair market values** of the properties which were acquired in said foreclosure proceedings at the dates acquired" **were $114,500.**

This was an express finding "upon the ultimate question of fact upon which the rights of the parties depend" (*Botany Mills* v. *U. S.*, 278 U. S. 282, 290).*

That *finding of ultimate fact,* based on the uncontradicted testimony, **is not open to review here** (*Botany Mills* v. *U. S., supra; Philips* v. *Com'r,* 283 U. S. 589, 600; *Burnet* v. *Leininger,* 285 U. S. 136, 138-9).

This Court and the various C.C.A. have repeatedly refused to review questions raised by taxpayers, upon the ground that where the B.T.A.'s Findings of Fact were *against* the taxpayer and were supported by *any* substantial evidence, the findings were not reviewable by the Court.

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*In order to foreclose any possibility of the point raised in the *Botany Mills* case, and to present the naked legal question here involved, the B. T. A. embodied its ultimate finding in the very language of Reg. 74, Art. 193 dealing with the value of property bid in by a mortgagee in foreclosure proceedings (although Art. 193 is, in our opinion, not applicable to life insurance companies, p. 6, ***supra***).

As there, so here.

Here, the B.T.A. has found the ultimate fact *in favor of* the taxpayer. Its finding should not be re-examined.

We, therefore, start out with the undisputed **judicially determined fact** that "the fair market values of the properties which were acquired in said foreclosure proceedings at the dates acquired" were only $114,500.

SECOND POINT.

The Midland Mutual did not "receive", *in cash or in property*, the $5,456.99 accrued interest (or any part thereof); and, therefore, the $5,456.99 was not "gross income" in 1930 (or at any time) under §202, Revenue Act of 1928.

1. Neither the mortgagors nor any third party paid any cash whatever to the Midland Mutual on account of either the defaulted debts or Interest. The Midland Mutual certainly *never received* any part of the $5,456.99 Interest, *in cash* from anyone.

2. All that the Midland Mutual received was title to the foreclosed properties; and, as we have just demonstrated (pp. 8-9, *supra*), the "fair market values" of those properties was only $114,500, which was $9,000 *less* than the principal debt alone (exclusive of all Interest).

The Midland Mutual did not, therefore, receive its *full principal* debt even *in property*. It did not re-

ceive a dollar's worth of property on account of its defaulted Interest.

Indeed, as shown at pp. 2, 4, 9, *supra,* the Midland Mutual actually lost nearly $9,000 of its principal [to be exact, $8,923.57], and its entire $15,538.60 *accrued Interest*—an actual $24,462.17 total money loss on its mortgage investment. And yet, the Commissioner held that $5,456.99 "of income [had been] received during the taxable year [1930] from interest"—*a reductio ad absurdum.**

If, immediately upon acquiring title to the properties, the Midland Mutual had sold them, it would have received only $114,500, as that was their "fair market value"; and by very definition, "fair market value" is the sum at which property may be sold "by one who is willing, but not obliged, to sell, and bought by one willing, but not obliged, to buy" (Cf. *Muser* v. *Magone,* 155 U. S. 240, 249). But according to the Commissioner's theory, the Midland Mutual collected its full $123,423.57 principal debt *plus* $5,456.99 of Interest, notwithstanding the fact that if it had sold the properties the day it acquired them, it would have lost, (as it actually did lose) $24,462.17 of its investment!

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*The value of the property acquired at foreclosure must be first applied to the *principal* debt, (including court costs, taxes, insurance, etc., which by the terms of the mortgage constitute additions to principal); and if the value does not exceed such amounts, no interest income is received. If the value exceeds such amounts, the excess value is next applied to pay the interest, and to that extent interest income is received, and is, of course, taxable (*Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 185; *Drier* v. *Helvering,* 72 F. (2d) 76, 77; *John Hancock Mutual Life Ins. Co.,* 10 B.T.A. 736, 739; *American Central Life Ins. Co.,* 30 B.T.A. 1182, 1190(b)).

As no one paid $5,456.99 *cash* to the Midland Mutual, and as no one conveyed to the Midland Mutual any property worth as much as its *principal* debt, *there could not have been* $5,456.99 "income received during the taxable year from interest" (§202 Rev. Act 1928).

No amount of argument can strengthen the bare undisputed facts (1) that during 1930, the Midland Mutual *did not receive any cash* on account of the mortgage principal or interest indebtedness; (2) that it did not receive anything else of any kind whatever, except a conveyance of the mortgaged property, which was worth about $9,000 *less* than the *principal* debt; and, hence, (3) that no part of the property so acquired was applicable to, or was applied towards, the payment of the defaulted Interest.

3. The Midland Mutual did not capitalize any part of the delinquent interest; did not treat it as income in any way; did not, directly or indirectly, carry it as any part of the cost of the properties or as an asset; and did not include such interest as an asset or otherwise, in its annual statement or in its reports to insurance department (R. 13, 20; p. 3, *supra*).*

*The Government relies on cases where the B.T.A. carefully pointed out that the taxpayers had treated the accrued interest as income for all purposes, and had carried the foreclosed properties into their books *as an asset*, at the full amount of the debt *and interest* (*Missouri State Life Case*, 29 B.T.A. at 407, 78 F. (2d) at 780; *National Life Ins. Case*, 4 F. Supp. at 1005; *Reserve Loan Life Case*, 18 B.T.A. at 364; *American Central Life Case*, 30 B.T.A. at 1187, 1190).

In *Manomet Cranberry Co.*, 1 B.T.A. 706; *Ewen MacLennan*, 20 B.T.A. 900; and *Prudential Ins. Co.*, 330 B.T.A. 332, it is not perfectly clear that the properties were carried on the taxpayer's books as an asset, in the amount of the debt *and interest;* but, however that may be, those cases are entirely distinguishable on another ground, in that the property was apparently worth *more* than the price at which it was "bid in"; in which event, of course, the taxpayer did "receive" the interest *in property*. That fact distinguishes the *Midland Mutual* case from all cases heretofore considered.

THIRD POINT.

The Midland Mutual's $128,880.56 "bid" at the foreclosure sale did not *conclusively* establish that the fair value was $128,880.56. The fair value was only $114,500 as found by the B.T.A.

1. *A "bid" price is not conclusive as to "fair value."* In response to the Government's contention that the foreclosure "bids" conclusively established the "fair value" of the property at $128,880.56—a view contrary to the B.T.A.'s latest decision on that subject*; and, that, therefore, the Midland Mutual had "received" *in property* its entire principal debt *with $5,456.99 Interest,* the C.C.A. said (R. 21):

> "There is urged upon us the existence of a *presumption* that at foreclosure sales the bid price *is* the fair market value of the property. Whether so or not, and this we do not decide, certainly *the presumption* by all familiar rules *must disappear* in the face of unchallenged and uncontroverted evidence that the fair value of the property is less. We know neither reason nor authority for such presumption being given *conclusive* effect. If so, foreclosure sales could never be set aside for inadequacy of price, however gross or shocking to the conscience such inadequacy might be."

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*In *La Arcada Bondholders Committee,* 35 B.T.A. (November 17, 1936), a Bondholders Committee was the sole bidder at a foreclosure sale. The B.T.A. said:

> ". . . the *bid* price . . . *is not conclusive* of cost of depreciable property acquired in foreclosure . . ."

The Syllabus reads:

> "1. . . . the cost of a building acquired upon foreclosure by the bondholders after a single conventional bid of one-half the amount of the outstanding bonds *is not conclusively fixed by the bid price* . . ."

That view is sustained by *Ballentyne* v. *Smith,* 205 U. S. 285, where a foreclosure sale was duly advertised, open and public; no fraud, restricted bidding, or lack of buyers shown; and the accepted bid was the highest. Nevertheless, a judicial foreclosure sale was set aside because,

> "the actual value of the property was at least seven times the amount of the bid" (p. 291). [To the same effect, see 35 C. J. 102, note 19; Cf. *Graffam* v. *Burgess,* 117 U. S. 180.]

The Government's contention is thus refuted, because if, as in the *Ballentyne* case, even a stranger's bid is not conclusive as to the property's value, *a fortiori,* a mortgagee's mere formal "bid" to protect himself, is not conclusive (pp. 14-17, *infra*).

The B.T.A. found *as a fact* that the fair value was $114,500.

Which is to prevail—the fact or a supposed conclusive presumption?

2. *The bids of a mortgagee and a third party occupy essentially different relations to the property's "fair value."* The Government has the erroneous view that when a mortgagee "bids in" property at a foreclosure sale, it is identically the same (not only in *legal effect,* but also in *establishing* value) as if a *stranger* had "bid" the same amount and *paid it in cash* to the mortgagee.

The two situations are very different.

This Court recognized that difference when it held that the Frazier-Lemke Act deprived the mortgagee

of "the following property rights" (*Louisville Bank* v. *Radford*, 295 U. S. 555, 594):

> "2. The right to realize upon the security by a judicial public sale . . .
>
> "4. The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale *or by taking the property itself.*"

The italicized words indicate the distinction between the mortgagee (*a*) receiving from a third party the proceeds of a foreclosure sale, or (*b*) *taking the property itself* through a "bid" at the sale.

It has always been the fundamental law in this country and the very essence of a mortgage, that the mortgagee has the right to have the *property devoted to the satisfaction of his debt;* and, if necessary, to have a sale of the mortgaged property, at which the mortgagee can protect himself by bidding in the property.*

In *Louisville Bank* v. *Radford*, 295 U. S. 555, 578-581, 594, there is an admirable exposition of the rights of a mortgagee. In that case, the mortgagee offered to

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*See Wehle, *Railroad Reorganization Under Section 77 of the Bankruptcy Act: New Legislation Suggested* (1934), 44 Yale L. J., 197, 212:
"Under Anglo-American law, since long prior to 1787, the mortgagee on foreclosure sale has had the optional right either to accept the proceeds of a fair competitive sale (if not more than the amount of his claim), or, if the highest bid at such a sale be insufficient to pay the debt, to bid in the property for himself and have the amount of his bid credited on the mortgage debt; in other words (aside from the right to a deficiency judgment), the mortgagee has traditionally had an optional right either to the proceeds of a fair competitive public sale, or to the property itself. As to the right of the mortgagor to have the property for the amount of the debt, this is so generally familiar as to require no exposition here."

pay $9,205.09 in cash for the mortgaged property, and if accepted,

> "all the money paid in in cash would be immediately returned to it in satisfaction of the mortgage indebtedness" (295 U. S., at 577).

The Frazier-Lemke Act attempted to compel the mortgagee to accept (in satisfaction of its debt) $4,445, which was the *appraised* "fair and reasonable value" and "market value" of the property.

This Court held that even the "bankruptcy" power could not take away *a mortgagee's right to the thing pledged;* that despite centuries of efforts to protect necessitous mortgagors (pp. 578-586, 594), there still remained intact the very essence of a mortgage, *i. e.,* the mortgagee's inviolable right either to receive his full debt with interest in cash, or **to take the property itself;** and that

> "To protect his right to full payment **or the mortgaged property,** the mortgagee was allowed to bid at the judicial sale on foreclosure" (p. 580 and elaborate note).

The whole point of the *Radford* case was that no matter what the fair or market value was, the mortgagee had the right to full *cash* payment (with interest) or **to take the property itself.**

So here. The Midland Mutual was unable to collect its debt with interest *in cash.* Consequently, **it took the property;** but the act of taking did not establish, certainly *did not conclusively establish,* what its "fair value" was.

The Government simply ignores the fundamental fact that when a mortgagee "buys in" property, he does not pay in cash *as a stranger does;* neither does he pay his bid with anything that is worth in cash even the amount of the bid—he simply **gets the thing pledged,** through a judicial foreclosure sale, instead of by a strict foreclosure.

The conventional plan of the mortgagee "bidding in" the property, and then paying for it by a credit on his judgment-debt [while unsecured judgment creditors may get nothing, 295 U. S. at p. 588], is merely the necessary judicial machinery by which, instead of the old automatic foreclosure on default, a judicial sale is provided in order to obtain the highest possible price for the debtor's benefit, and, at the same time, to preserve inviolable the creditor's right to a full cash payment of his debt **or to take the property itself** (pp. 579-581, 584; See 35 C. J., p. 53; 42 C. J., p. 208).

A "bid" represents nothing more than the mortgagee's exercise of his immemorial right to protect his interest in the mortgaged property. His "bid" is merely the enforcement of his mortgage lien and it has no conclusive effect as to the actual fair value of the property purchased. A $100,000 mortgage may be foreclosed on property worth $30,000; and when the mortgagee "bids" it in for (say) $50,000, such "bid" does not *conclusively* establish the "fair value" of the property.

The C. C. A. expressed the same idea when it so aptly stated (and answered) the Government's contention as follows (R. 20):

> "The deficiencies were asserted . . . on the ground that a bid at foreclosure sale by the mortgagee *establishes* the market for the particular property sold and is *determinative* as to receipt of income by the mortgagee. This is because the *legal effect* of such sale is said to be the same as though the mortgagee paid the full amount of its bid in cash and then received in cash the full amount of its debt, so that interest is received by it in cash or its equivalent . . .
>
> "Whatever may be the *legal effect* of a foreclosure sale upon the passing of title and the extinguishment of the mortgage debt, the *fact* indisputably remains that when the mortgagee buys in the property *he does not pay cash.* The law permits him to set-off the debt against the obligation created by his bid. **This distinction is vital in determining whether he has received income.** Without possessing the debt the mortgagee would not bid. He is primarily a lender and a purchaser only through necessity. To say that he pays cash and receives cash **is to fly in the face of the realities.** A mortgage lien upon property of a defaulting mortgagor is generally worth no more than the fair value of the security. It is true that the law invests it with the virtue of currency, but only for a limited and definite purpose—the purchase of the mortgaged property. We are unable to see by what alchemy this baser metal is transmuted into gold through the mere formalities of a foreclosure sale."

3. *The "equivalent" or "exchangeable" value argument.* The Government next insists (Brief, pp. 12, 16, 17), that even if the Midland Mutual did not receive $5,456.99 in actual cash (as of course it did not), still it did receive $5,456.99 in one or the other of the following ways:

(*a*) GOVERNMENT'S BRIEF, pp. 17-19: "*Property of an equivalent value* . . . as shown by the taxpayer's voluntary bid at a public sale, that the *property* in question was worth, to the respondent [Midland Mutual] the full amount of its unpaid principal and accrued interest . . . the *property received* may properly . . . be treated as cash to the extent of its *value*" . . . ". . . where, as here, property is received of the equivalent value of a cash payment of the interest, the statute requires that, to such extent, interest be included in the gross income of the recipient."

Thereby, the Government simply re-asserts that a mortgagee's "bid" finally and conclusively establishes the cash value of the property as the amount of the "bid"—a proposition that is refuted, *firstly,* by the B.T.A.'s *finding of fact* that the value was only $114,500, and, *secondly,* by our argument (pp. 12-13, *supra*) that a "bid" is not conclusive as to value (*Ballentyne* v. *Smith*), and that a *mortgagee's* "bid" does not establish "value," even as much as a stranger's bid.

(*b*) GOVERNMENT'S BRIEF, pp. 12, 16: An indefinite "benefit" or "something of exchangeable value" which requires the mortgagor, *if he redeems the property during the redemption period,* to pay both the debt and $5,456.99 interest.

To that we respond;

First; that the "benefit"—if there be a benefit—is not *income;* even if income, it certainly is not "from interest;" and, hence, it is not "income" within §202;

Second; that the alleged "benefit" is, at most, merely the right to compel the mortgagor either to pay the debt with interest, or let the mortgagee take the

property—but the mortgagee already had that inherent right even *before* the sale. Consequently, he did not, by the sale, acquire a *new* "benefit" worth $5,456.99.

Third; what *is* the "something of exchangeable value" which "the taxpayer has received"? "Exchangeable" for *what?* And for *how much?* The Government's Brief is silent on those points.

The C.C.A. aptly said (R. 21):

> "It is said on behalf of the respondent that by bidding the full amount of its debt the mortgagee secured protection against the mortgagor's redemption; that having acquired a *benefit* it should pay the tax regardless of the value of the property. **But a benefit is not necessarily income.** That need not be demonstrated. Here it is clearly not a gain derived from capital, or received or drawn by the taxpayer for its separate use, benefit and disposal.
>
> The property may be redeemed. In that event income is derived to the extent of interest included in the redemption price. Then interest is paid, and likewise received.
>
> But the property may not be redeemed. Is the realization in the one case no more in respect to the creation of income than mere expectation in the other? We think to put the query is to answer it. As was further said in *Eisner* v. *Macomber,* "It becomes essential to distinguish between what is and what is not income . . .; and to apply the distinction, as cases arise, according to truth and substance, without regard to form.' "

To amplify that argument a little, let us consider two separate properties of *equal value,* subject to equal liens, and "bid in" for the same sum.

In one case, the mortgagor redeems; and the mortgagee receives *in cash* the full debt *and interest.*

In the other case, there is no redemption, and the mortgagee owns the property whose "fair value" (as in the first case) is only 80% of the principal debt.

According to the Commissioner, the mortgagee "received" the *full interest* equally in *both* cases. But the C.C.A. said (R. 21);

> "Is the *realization* in the one case no more in respect to the creation of income than mere *expectation* [never realized] in the other?"

4. If, in order to avoid foreclosure expenses, etc., the mortgagor *voluntarily* conveys the property to the mortgagee in full satisfaction of the debt and interest, and the property is worth *less* than the debt, the Commissioner now concedes that no income has been received, and that the mortgagee has not "received" any interest (*Helvering* v. *Missouri State Life Ins. Co.,* 78 F. (2d) 778, 780 [3, 4] reversing the B.T.A.'s decision [29 B.T.A. at p. 408] in favor of the Com'r on that point; Cf. *Prudential Insurance Co.,* 33 B.T.A. at p. 334; *American Central Life Ins. Co.,* 30 B.T.A. at p. 1190 [a]).

Let us assume that life insurance companies "A" and "B" each have a mortgage of $10,000 with $600 accrued interest on lots "X" and "Y", each worth only $7,000.

Company "A" receives a voluntary conveyance of "X" from the mortgagor, and cancels the $10,600 indebtedness. There is no income or interest received by "A" (78 F. (2d) 778 at p. 780 [3, 4].

Company "B" forecloses on lot "Y" at an expense of $300, and "bids" it in for $10,900. Company "B" [$300 *worse off* than Company "A"] must, according to the Commissioner's theory, return $600 as interest received, and pay the tax thereon.

The C.C.A. thus exposed the fallacy in such a situation saying (R. 21):

> "The court in *Helvering* v. *Missouri State Life Insurance Co., supra,* made a distinction between surrender of mortgaged real estate by the mortgagor to the mortgagee and the purchase of the property by the mortgagee under foreclosure. It concluded that a transaction of the first kind produces no income by way of interest to the mortgagee, while one of the latter does. We are unable to grasp the principle which distinguishes them, and we think the differentiation will not withstand analysis. Where the defaulting mortgagor surrenders the mortgaged property in extinguishment of the debt, the mortgagee acquires as against him a clear title. Where the mortgagee buys the property at foreclosure, he does not get clear title, but one still encumbered by the mortgagor's right to redeem. It seems to us anomalous to hold that one who receives *less* derives income, while one who receives *more derives none.* Demonstrating its conclusion that the recipient of the surrendered mortgage derives no income from accrued interest, the court says: 'If the rule were otherwise, a life insurance company, all of the loans of which were in default and which was obliged to take over from its mortgagors mortgaged lands of little value in order to save the expense and delay of foreclosure, would be in the same situation with respect to interest received as though all of its loans were good and the interest had been paid

> in cash.' We fail to see in what better situation is a life insurance company which not only is obliged to take over from its mortgagors lands of little value, but is in addition subjected to the expense and delay of foreclosure. If the illustration is persuasive in the one case, we are unable to see how it can be any less so in the other."

5. This Court is so familiar with the nature of "income," that we need only add that *gain or profit* is the essential idea of "income";[1] and that in determining what constitutes "income", substance and fact rather than form are to be given controlling weight.[2]

Applying those recognized rules, how can it be said that the Midland Mutual had $5,456.99 "income received during the taxable year [1930] from interest" (§202) when it was unable to collect a dollar of interest from the mortgagors; was compelled to pay taxes, court costs, attorneys' fees, insurance, etc.; and finally had to "bid in" the mortgaged premises (which the B.T.A. found were only worth $114,500) as the sole return for a $138,962.17 mortgage investment—a clear loss of $24,462.17? (p. 2, *supra*).

Do not those "actual facts" show that it did not receive $5,456.99 (or any other sum) as interest in 1930 from those mortgage investments?

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[1] *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. at p. 185; *Eisner* v. *Macomber*, 252 U. S. at p. 207; *Goodrich* v. *Edwards*, 255 U. S. at p. 535; *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. at p. 175.

[2] *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. at p. 72; *Eisner* v. *Macomber*, 252 U. S. at pp. 211, 213-214; *U. S.* v. *Phellis*, 257 U. S. at pp. 168, 175; *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. at p. 174; Cf. *Chattanooga Sav. Bank* v. *Brewer*, 9 F. (2d) 982, 988, and *Southern Pac. R. Co.* v. *Muenter*, 260 Fed. 837, 838 (C. C. A. 9th), holding that the *actual facts* must control, regardless of record resolutions or systems of bookkeeping.

The stability of life insurance itself is based upon the assumption that the company will earn *compound interest at the rate assumed* in the calculation of the premium. Hence, as said in Gephart's Principles of Insurance, pp. 43, 46:

> ". . . this interest accumulation is a very important part of the principle upon which the companies operate. It is these interest accumulations which determine in part the premiums to be charged. . . .
>
> "The most important point to understand in connection with the interest accumulations is that it is not a simple interest accumulation, but a compound interest accumulation . . . the science of life insurance is based upon calculations involving mortality statistics and compound interest earnings.*"

The Commissioner's theory that a life insurance company "receives" interest, when, in point of fact, it cannot collect the interest from the mortgagors, and has to take over real estate of a "fair market value"

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*The best explanation of the absolute necessity for a life insurance company to be sure that it collects compound interest at the rate assumed in its calculation of premiums will be found in *Rhine* v. *New York Life* (App. Div.), 289 N. Y. S. 117, 121-123, 125; affirmed Dec. 31, 1936, —— N. Y. ——; *Maddox* v. *Mutual Life*, 193 Ky. 38, 43.

In view of the restricted character of life insurance investments, greatly lowered interest rates, and the vast amount of maturities and redemptions necessitating reinvestment at lower rates, it is practically impossible for life insurance companies now to reinvest those huge sums at more than a fraction of the rate which the companies assumed they would earn when they fixed their premium rates.

Temporarily, the magnitude of old investments maintains the average interest rate at perhaps a little above the rate assumed; but unless interest rates increase, it may not be a great while before the companies fail to earn the rate assumed in the fixing of the premiums, which means disaster when the interest deficit equals whatever saving the company can make in mortality and expenses.

greatly *less* than even the principal of the debt (thereby losing all of its interest), is obviously untenable, because the company could not pay its policy claims with such non-existent purely theoretical interest.

No beneficiary would accept in payment of a death claim, that which the Commissioner insists is "income received from interest"—because it is purely theoretical, and with it no one could purchase food, clothing or housing.

To be concrete: Suppose, in 1930, the Midland Mutual had discharged all of its policy obligations, except a single policy death claim of $128,880.56; and its only remaining asset was this property which it had "bid in" at foreclosure. We must assume that the property had a fair value of $114,500 (for so the B.T.A. found); and that means that the Company could sell the property for $114,500 (and no more), and pay $114,500 upon the policy claim. Where would the beneficiary get the remaining $14,380.56 of the insurance?

Putting aside the $8,923.57 loss of principal, let us center our attention upon the $5,456.99 which the Commissioner insists the Midland Mutual "received from interest" in 1930.

Where is it? It is non-existent for the purpose of paying the beneficiary, who is clamoring for the balance of his insurance. It is only existent for the purpose of being subject to a tax on that, which, in fact, does not exist.

An Illuminating Test.

Life insurance companies are taxed only upon their *investment* income. Capital "gains" and "losses" do not enter into the determination of their taxable income.

Notwithstanding that, however, what is a *capital* "gain" or "loss" for other taxpayers must likewise be a *capital* "gain" or "loss" for a life insurance company; and what is a *capital* "gain" or "loss" for other taxpayers *cannot possibly be income* for a life insurance company.

In other words, *capital* "gains" and "losses" cannot be transmuted into *income* simply because the recipient is a life insurance company.

With this in mind, let us assume the case of two foreclosed mortgages, one held by an ordinary taxpayer and the other held by a life insurance company—in each instance the situation being as follows:

Principal mortgage debt	$10,000.00
Defaulted interest	500.00
Total	$10,500.00
Bid	$10,500.00

"The fair market value of the property" is established by "clear and convincing proof" to be the respective sums hereafter used in the illustrations (Reg. 74, Art. 193).

(1) If the fair market value were $9,500, then the ordinary taxpayer would receive no income, but would

suffer a $500 *capital* loss, which it could deduct (Art. 193).

The life insurance company would likewise sustain a $500 *capital* loss, which it could not deduct because it is a life insurance company; but, according to the Commissioner's theory, the fair value is immaterial, and the life insurance company must return $500 *income.*

Can that which is a *capital loss* to an ordinary taxpayer, be taxable *income* to a life insurance company?

(2) If the fair market value were $10,200, the ordinary taxpayer would receive $200 income, while the life insurance company (according to the Commissioner's theory), would still receive $500 taxable *income*—although, in fact, each company *lost* $300 of interest income.

How can precisely the same situation produce $200 *interest* income to an ordinary taxpayer, and $500 *interest* income to a life insurance company?

(3) If the fair market value were $10,700, then the ordinary taxpayer would receive $500 interest income and $200 capital gain, while the life insurance company (according to the Commissioner's theory) would receive $500 interest income; and although actually realizing a $200 capital gain, it would not have to account for it for two reasons: (*a*) Capital "gain" provisions do not apply to life insurance companies, and (*b*) The $10,500 bid is *conclusive* of the fair value, regardless of the actual facts!

FOURTH POINT.

A review of the Government's authorities.

As the Government's argument consists principally of a quotation from the *Missouri State Life* case (C.C.A. 8th), and nearly four pages (Brief, pp. 10-11, 13-15), taken literally from the Court of Claims' opinion in *National Life Ins. Co.* v. *U. S.*, 4 F. Supp. 1000, a review of those two cases is all that is necessary.*

In *National Life Ins. Co.* v. *U. S.*, 4 F. Supp. 1000, a life insurance company foreclosed a number of mortgages in States where there were redemption laws. The Company (as the only bidder at the foreclosure sales) bid the full amount of the unpaid principal and accrued interest. The Company carried the purchased real estate as an asset to the value of the debt and interest; and included the interest as income in its annual statements to the Insurance Departments of the various States, as well as including it as income in its Federal Income Tax Returns. Later it sued for a refund of the tax on such interest.

The Court of Claims found that, at the date of foreclosure, some of the property had a "fair market

*The other cases cited are (1) the B.T.A.'s previous rulings on the same subject (Brief, pp. 8-9; reviewed p. 11, note, *supra*); (2) those cited in the *National Life* opinion (which with scarcely a changed word constitutes the Government's argument in its Brief, pp. 13-15); (3) *American Cigar Co.* v. *Com'r*, 66 F. (2d) 425, which was not a foreclosure case, but was a "bad debt" case, involving a loan to a debtor, *whereas* the "bad debt" provision does not apply to life insurance companies, and there was no loan here to the debtor; and *Duke Power Co.* v. *Com'r*, 44 F. (2d) 543, which was not a foreclosure case, but involved the right to file consolidated returns of affiliates.

value" equal to the debt and interest; and that some of the other purchased real estate was later sold for *more* than the debt and interest.

The opinion does not show that any of the purchased real estate had a "fair value" of *less* than the debt and interest; so that, as far as the opinion reveals, *all* of the purchased real estate may have had an actual "fair value" *more than* the debt and interest. If so, the National Life certainly realized either interest-income or a capital "gain"—in either instance a totally different situation from that presented in the Midland Mutual's case.

This difference between the facts in the *National Life* and *Midland Mutual* cases, respectively, not only prevents the *National Life* case from being an authority in the *Midland Mutual* case, but greatly lessens the value of its general reasoning as applied to the very different facts here involved.

In brief, the Court of Claims simply holds that when the National Life bid the amount of the debt and interest at the foreclosure sale, so as to obtain title free from the redemption laws, the transaction was exactly the same as if a stranger had bid the same sum, had paid it into Court, and the mortgagee had collected it in cash, in which event the mortgagee would have received the interest as taxable income.

It is useless to lengthen this Brief by considering separately the arguments taken from the *National Life* opinion, as the substance of each of them has already been thoroughly considered, analyzed and answered (pp. 9-26, *supra*).

In *Helvering* v. *Missouri State Life Ins. Co.*, 78 F. (2d) 778 (C.C.A. 8th), a life insurance company acquired mortgaged property in two ways: (1) at foreclosure sales, by "bidding" it in for the full amount of the principal debt with interest, and (2) by voluntary conveyances from the mortgagor, in consideration of the forgiveness of the entire indebtedness.*

With respect to mortgage foreclosures, the C.C.A. held that where the "bid" was equal to the principal debt with interest, the mortgagee had received the interest, regardless of whether the bid was by the mortgagee or by a stranger, disposing of the matter in the following summary fashion;

> "When mortgaged property is sold on foreclosure for an amount sufficient to pay the mortgage debt with accrued interest, the mortgagee has received payment in full of its debt, and that is so, regardless of whether the highest bidder at the sale is the mortgagee or a stranger. Where a stranger buys, he pays cash to the officer making the sale, who pays it to the mortgagee. Where the mortgagee buys the property, instead of paying cash to the officer and receiving it back, he credits the amount which he, as purchaser, bids, upon the mortgage debt. In either event, he receives payment in cash or its full equivalent." [Citation omitted.]

This argument has been fully answered at pp. 13-17, *supra*.

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*The C.C.A. (8th) held that in the cases of voluntary conveyance, if the land was worth as much as or more than the debt with interest, the Company had received the interest income; but if the property was worth *less* than the principal debt, no interest was received.

As there were no findings as to the "fair value" of the properties voluntarily conveyed, the case was remanded on that point.

The *Missouri State Life* case is not really in point, because, so far as the 8th Circuit's opinion discloses, the "fair value" of the foreclosed property may have been a *great deal more than* the entire principal debt, costs, *and all accrued interest,* in which event it would present an entirely different situation from that of the Midland Mutual, where the B.T.A. has found that the "fair value" of the property was actually *less* than the principal debt alone.

If we turn back to the B.T.A's opinion in the *Missouri State Life* case (29 B.T.A., pp. 407-408), it appears that there was much testimony in the record upon the question of the "fair market values"; but the B.T.A. (thinking that point immaterial), made no express findings on the subject, except to say that the fair market values of *some* of the properties were less than the loan, *plus* accrued interest. From the context, it would seem that it referred to properties where *voluntary conveyances* had been made. However that may be, in any event most of the foreclosed properties may have had a "fair value" greatly in *excess* of the principal debt *and all interest thereon.*

The great difference between the clear, undisputed facts in the *Midland Mutual* case and the very different facts in the *National Life* and *Missouri State Life* cases prevents the latter from being a direct authority.

CONCLUSION.

The judgment should be affirmed.

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Counsel for Respondent.

4 January 1937,
Louisville, Ky.

[See pages 32-34, *infra*, for Appendix.]

APPENDIX.

METHOD OF TAXING THE INCOME OF LIFE INSURANCE COMPANIES FROM 1913 TO 1936.

In view of the Government's repeated reference to, and reliance upon, the fact that life insurance companies are not subject to the capital "gains" and "losses" provision of the income tax law; its insistence that they have received "privileged treatment . . . different from that of other corporations and individuals"; and the erroneous inferences drawn therefrom (Government Brief, pp. 7, 15, 19), the following review is submitted:

1913-1920. The Revenue Acts of 1913, 1916, 1917 and 1918, taxed life insurance companies upon their *net income;* and all *premiums* paid in by policyholders were included as "*gross* income." On account of the peculiar nature of the life insurance business, Congress allowed certain large *special deductions,* summarized in the margin,* in order to exclude from "*net*" income the enormous sums which the companies (1) paid out to policyholders, or (2) were compelled to retain as legal "Reserve" to meet future death losses as they should occur (*Maryland Casualty Co.* v. *U. S.,* 251 U. S. 342, 346-8; BRANDEIS, J. dissenting in *National Life Ins. Co.* v. *U. S.,* 277 U. S. 508, 522-523; *Helvering* v. *Ind. Life Ins. Co.,* 292 U. S. 371, 379; *Rockford Life Ins. Co.* v. *Comr.,* 292 U. S. 382, 383, 385).

*The special deductions so allowed (1913-1920) were, to wit; (1) the net addition required by law to be made within the taxable year to Reserve funds; (2) sums other than dividends paid within the taxable year on policy and annuity contracts; and (3) in the 1918 Revenue Act, such portion of any actual premium received from any individual policyholder as is paid back or credited to, or treated as, an abatement of premium of such policyholder within the taxable year (Act Oct. 3, 1913, Section II G(b), 38 Stat. 172-3; Revenue Act of 1916, § 12(a), 39 Stat. 767-8; Revenue Act of 1917, 40 Stat. 302-305; Revenue Act of 1918, §§ 233(a)(1), 234(a)10, 40 Stat. 1077, 1079; Compare Act August 5, 1909, § 38, 36 Stat. 113).

This was so, on exactly the same theory that if Congress includes in a bank's income *all the money deposited in the bank by its depositors during the year,* it must either (*a*) make the tax infinitesimally small or (*b*) allow as a *deduction,* all the checks drawn by depositors during the year *plus* the amount owing to depositors at the end of the year.† In the *National Life* case Solicitor General MITCHELL expressly so conceded, aptly saying that *premiums*

> "*are no more income to the company* than are *deposits* in a bank *income to the bank*" (Brief, p. 12).

Otherwise, both the banking and insurance businesses would be taxed out of existence.

That treatment of premiums as "income," with corresponding special deductions, was productive of administrative difficulties and much litigation (*McCoach* v. *Insurance Co.,* 244 U. S. 585; *Maryland Cas. Co.* v. *U. S.,* 251 U. S. 342; *U. S.* v. *Boston Ins. Co.,* 269 U. S. 197; *New York Life Ins. Co.* v. *Edwards,* 271 U. S. 109; *Duffy* v. *Mutual Benefit Co.,* 272 U. S. 613 BRANDEIS, J., in *National Life Case,* 277 U. S. at 523; *Helvering* v. *Ind. Life Ins. Co.,* 292 U. S. 371, 379).

1921-1936. The 1921 Revenue Act simplified the taxation of life insurance companies by adopting a new method, which has been followed in all the subsequent Revenue Acts of 1924, 1926, 1928, 1932, 1934 and 1936 (p. 5, note, *supra*). This new method was not an arbitrary favor or "privileged treatment" [as the Government asserts, Brief, p. 19]; but, as Mr. Justice Brandeis (dissenting) said in *Nat'l. Life Ins. Co.* v. *U. S.,* 277 U. S. 508, 535,

†Cf. *Deposit Bank of Owensboro* v. *Daviess County,* 102 Ky. 174 at 214; *Com.* v. *Bank of Commerce,* 118 Ky. 547, 551-556; *Com.* v. *Wathen,* 126 Ky. 573, 574; *Branch* v. *Town of Marengo,* 43 Ia. 600; *People* v. *Peck,* 157 N. Y. 51; *In re Haight,* 32 App. Div. 496; *State* v. *Carson Savings Bank,* 17 Nev. 146; *State* v. *American,* 37 N. J. Law, 408; *Petition of Savings Bank,* 68 N. H. 384; *Berry* v. *Windham,* 59 N. H. 288; *Clement Nat. Bank* v. *Vermont,* 231 U. S. 120.

> "The new method of taxation was intended by Congress to procure *additional revenue* from the insurance companies." House Report 67th Congress, 1st Session, No. 350, p. 14."

The new method *eliminated premiums* from "gross income," by defining "gross income" to include *only* such income as was "*received* during the taxable year" from "*interest, dividends and rents*" [§244(a)].

On the other hand, it *eliminated* many *deductions* which *other* corporations were allowed [Cf. §§234(a), 245(a)].*

The new 1921 method (which is still in force after sixteen years) was not some "privileged treatment" which the companies secured as a favor from Congress. It was the result of several years' careful consideration by the Treasury Department and by Congressional Committees in an effort *to collect more taxes* from life insurance companies than had been possible under the previous Revenue Acts taxing life insurance companies and allowing them capital "gains" and "losses," etc., like other corporations (Cf. §§246(a)(1)(2), 247 of Senate Amendment to Revenue Act of 1918 (Senate Report No. 617, 65th Cong. 3d Sess. H. R. 12863); Hearings before the Senate Committee on Finance, on H. R. 8245, 67th Cong., 1st Sess., p. 84, September 1-October 1, 1921. See also S. Rep. No. 275, 67th Cong., 1st Sess., p. 20; §§244(a), 245(a)(1)(2) Revenue Act of 1921, 42 Stat. 261. Cf. BRANDEIS, J., in *National Life* case, 277 U. S. at 523 note; *Helvering v. Ind. Life Ins. Co.*, 292 U. S. 371, 379; *Rockford Life Ins. Co. v. Comm'r*, 292 U. S. 382, 385).

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*In lieu of the former (1913-1920) special deductions noted in the margin (p. 31, *supra*), the 1921 Act allowed *only nine deductions* specifically itemized in the nine separate numbered paragraphs of §245 a), (1) to (9).

These deductions were not an arbitrary favor or "privileged treatment," but were an *economic necessity*, so long as there was any pretense of "income" taxation; though, constitutionally, Congress might have refused any deduction, and taxed the life insurance business into insolvency.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

No. 257.

GUY T. HELVERING, Commissioner, Etc., - Petitioner,

versus

MIDLAND MUTUAL LIFE INSURANCE COMPANY, - - - - - - Respondent.

PETITION FOR A MODIFICATION OF THE OPINION.

F. J. WRIGHT,
JOHN E. TARRANT,
WM. MARSHALL BULLITT,
Counsel for Midland Mutual Life Insurance Company.

WESTERFIELD-BONTE COMPANY, INCORPORATED, LOUISVILLE, KY.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

No. 257.

GUY T. HELVERING, COMMISSIONER, ETC., - *Petitioner,*

v.

MIDLAND MUTUAL LIFE INSURANCE COMPANY, - - - - - - - *Respondent.*

PETITION FOR A MODIFICATION OF THE OPINION.

Midland Mutual petitions for a modification of the opinion because of its statement:

> "We cannot say that Congress did not intend to include in its definition [*i. e.*, of the gross income of life insurance companies] a case like the present merely because the taxpayer *received a credit rather than money or other tangible property.*"

We suggest that Congress did not intend a foreclosure bid to be the criterion for determining income, gain or loss; but intended the criterion to be the "*fair market value of the property*" *bought in.*

Continuously since 1926, the "bad debt" provision of the Regulations has provided that:

> "In addition, [to the amount of mortgage indebtedness remaining unsatisfied after foreclosure sale and ascertained to be uncollectible] where the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property * * * and *the fair market value of the property.* The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer *in the absence of clear and convincing proof to the contrary.* If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is *the fair market value of the property at the date of acquisition.*" (Reg. 69, Art. 153; Reg. 74, Art. 193; Reg. 77, Art. 193; Reg. 86, Art. 23(k)-3; Reg. 94, Art. 23(k)-3.)

By concurrence in this Regulation, through the reenactment without change of the "bad debt" provision of the various Revenue Acts (U. S. v. Cerecedo Hermanos Y Compania, 209 U. S. 337, 339) Congress showed that the criterion for determining gain or loss of taxpayers, (other than insurance companies) is the "*fair market value* of the property" bought in at foreclosure sale, and *not the amount of the bid* at the foreclosure sale, or the amount of the judgment credited on that bid.

Congress has not used any language in its definition of an insurance company's "gross income" to indicate

that what is a *capital loss* to an ordinary taxpayer is taxable *income* to a life insurance company.

F. J. WRIGHT,
JOHN E. TARRANT,
WM. MARSHALL BULLITT,
Counsel for Midland Mutual Life Insurance Company.

March 31, 1937.

I certify that this petition is presented in good faith and not for delay.

JOHN E. TARRANT.

SUPREME COURT OF THE UNITED STATES.

No. 257.—October Term, 1936.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* The Midland Mutual Life Insurance Co.	On Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[February 15, 1937.]

Mr. Justice Brandeis delivered the opinion of the Court.

Since 1921, the Revenue Acts have made this provision for taxing the income of life insurance companies.[1] The gross income is limited to that "received during the taxable year from interest, dividends, and rents." Upon the net income, ascertained by making prescribed deductions, the tax under the Act here applicable is 12 per cent.[2] The general provisions of the Revenue Acts concerning capital "gains and losses" and "bad debts" are not applicable to life insurance companies.[3]

In 1930, the Midland Mutual Life Insurance Company of Ohio caused to be foreclosed several mortgages on real estate given to secure loans which were in default. It was the only bidder; its bid was accepted; the property was conveyed to it; and in no case was there redemption. At each foreclosure sale the company had bid an amount which included interest as well as the principal. The interest so bid, aggregating on the foreclosed mortgages $5,456.99, was not included in the company's income tax return. The Commissioner of Internal Revenue decided that this interest was taxable and, accordingly, determined a deficiency in the company's income tax for 1930. His determination was approved by the Board of Tax Appeals. The Circuit Court of Appeals reversed the decision of the Board, 83 F. (2d) 629. We granted certiorari because of conflict with *Helvering* v. *Missouri State Life Ins. Co.*, 78 F. (2d) 778, and *National Life Ins. Co.* v. *United States*, 4 F. Supp. 1000.

[1] See National Life Insurance Co. *v.* United States, 277 U. S. 508, 522.

[2] Revenue Act of 1928, § 201 (b) (1), 45 Stat. 791, 842.

[3] Compare §§ 244 (a), 245 (a), of the Revenue Acts of 1921, 42 Stat. 227, 261; 1924, 43 Stat. 253, 289;; 1926, 44 Stat. 9, 47; §§ 202 (a), 203 (a), of the Revenue Acts of 1928, 45 Stat. 791, 842; 1932, 47 Stat. 169, 224; 1934, 48 Stat. 680 731 32; 1936, 40 Stat. —, 1017. See Helvering *v.* Independent Life Insurance Co., 292 U. S. 371, 377, 379; U. S. Treas. Reg. 74, Art. 951.

The following additional facts stipulated were adopted by the Board of Tax Appeals as its findings: The Company kept its books on a "calendar year" "cash receipts and disbursements" basis, entering only payments of interest actually made to it during the year. Upon its acquiring title to the foreclosed properties, the investments were transferred on its books from the mortgage loan account to the real estate account and were carried thereon as assets at amounts which were equal to the principal of the loans secured by the mortgages plus any disbursements made for taxes, court costs, attorneys fees or insurance premiums. The amount of interest included in the bids on foreclosure was not carried on the books as part of the cost of the properties or as an asset. Nor was it entered on the books or likewise treated as income. All of the properties here involved were located in States where a period of redemption from foreclosure is allowed. The company issued to its representatives having charge of foreclosures in those States general instructions to bid on its behalf such sums as would enable the company to realize no loss on account of its investment in case of redemption. The bids here involved were made pursuant to those instructions, without regard to the then actual value of the mortgage property.[4]

The company introduced evidence that the fair market value of the properties was, at the dates of foreclosure and of acquiring title, less than the amount of the principal due on the mortgages. This evidence was deemed by the Board immaterial; and it accordingly made no finding as to fair market value.[5]

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[4] A large majority of the properties were located in Michigan. By Michigan law, it is said, the mortgagor is allowed one year from the date of the foreclosure sale within which he may redeem the property by paying to the purchaser the amount bid for the property plus interest from the time of the sale at the rate borne by the mortgage, even though the amount of such bid be less than the total amount of the mortgagee's investment in the property. See Comp. Laws 1929, c. 266, §§ 14435, 14436; compare Vosburgh *v.* Lay, 45 Mich. 455. The purchaser cannot, under the local law, acquire title until after the expiration of the redemption period. See Comp. Laws 1929, c. 266, § 14434. The mortgagee may, "fairly and in good faith", bid the property in, (*id.*, § 14432), and he enjoys the same rights as purchaser as would a third party. See Ledyard *v.* Phillips, 47 Mich. 305, 308.

[5] The order of the Court of Appeals, which reversed the decision of the Board, remanded the cause for further proceedings. We are told by counsel for the company that thereafter the Board found, on the evidence above referred to, that the values of the several properties were less than the principal of the loans. This finding, made after the filing of the petition for certiorari, though apparently before its allowance, was not made part of the record. It is, therefore, disregarded.

First. The company contends that it did not "receive" the $5,456.99 (or any part thereof) either in cash or in property; and, hence, that it was not "gross income." Confessedly no interest was received in cash. The company insists that none was received in property. It argues that its bid may not be taken as conclusive evidence of the value of the property, invoking *Ballentyne* v. *Smith,* 205 U. S. 285; that the Board's refusal to consider the evidence as to value requires us to hold that the real estate acquired on foreclosure was of a fair value less than the amount of the principal of the mortgage debt; that the proceeds of a mortgage sale must be applied first to the satisfaction of the principal before income may be held received, citing *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 185; and that since the value did not equal the principal, there were no proceeds of the sales applicable to the interest, hence, no taxable income. In support of this argument, the company points to the fact that it did not, on its books, treat the delinquent interest as income; did not, directly or indirectly, carry the interest as part of the cost of the properties or as an asset; and did not include the interest as an asset in its annual statement or in its reports to insurance departments.

The arguments rest upon a misconception. The terms "interest," "dividends," and "rents," employed in the statute simply and without qualification or elaboration, were plainly used by Congress in their generic meanings, as broadly descriptive of certain kinds of "income." Compare *Lynch* v. *Hornby,* 247 U. S. 339, 344; *Helvering* v. *Stockholms Enskilda Bank,* 293 U. S. 84, 86. We cannot say that Congress did not intend to include in its definition a case like the present merely because the taxpayer received a credit rather than money or other tangible property. Compare *Raybestos-Manhattan, Inc.* v. *United States,* 296 U. S. 60, 62, 64. A receipt of interest is taxable as income whether paid in cash or by a credit. Compare *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716; *United States* v. *Boston & Maine R. R., id.,* 732. This credit, it is true, was not entered on the taxpayer's books as interest or as an asset. But book-keeping entries, though in some circumstances of evidential value, are not determinative of tax liability. Compare *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 187. The intent to use the full extent of power being clearly evident, we must not confine the legislation within narrower forms than the statutory language

would indicate. Compare *Irwin* v. *Gavit*, 268 U. S. 161, 166; *Helvering* v. *Stockholms Enskilda Bank*, *supra*, 89.

Second. The company argues that uncontradicted evidence shows the fair market value of the mortgaged properties to have been less than the principal of the debts and that therefore the interest paid was not income within the meaning of the Act. A mortgagee who, at foreclosure sale, acquires the property pursuant to a bid of the principal and accrued interest is, as purchaser and grantee, in a position no different from that of a stranger who acquires the property on a bid of like amount. It is true that the latter would be obliged to pay in cash the amount of his bid, while the formality of payment in cash is ordinarily dispensed with when the mortgagee acquires the property on his own bid. But the rights acquired *qua* purchaser are the same in either case; and, likewise, the legal effect upon the mortgage debt is the same. In each case the debt, including the interest accrued, is paid. Where the stranger makes the purchase, the debt is discharged by a payment in cash; where the mortgagee purchases the property, the debt is discharged by means of a credit. The amount so credited to the mortgagor as interest paid would be available to him as a deduction in making his own income tax returns.[6] It would be strange if the sum deductible by the mortgagor debtor were not chargeable to the mortgage creditor as income received. Where the legal effect of a transaction fits the plain letter of the statute, the tax is held payable, unless there is clearly revealed in the Act itself or in its history a definite intention to exclude such transactions from the operation of its applicable language. See *Central National Bank* v. *United States*, 137 U. S. 355, 364;[7] *Treat* v. *White*, 181 U. S. 264, 268; *Provost* v. *United States*, 269 U. S. 443, 456, 457, 458; *Old Colony R. R. Co.* v. *Commissioner*, 284 U. S. 552, 560, 561. Respondent here makes no such showing.

Third. The company argues that taxation is a practical matter; that we should be governed by realities; that the reality is, that all the company got was the property; and that the property was worth less than the principal of the debt. The "reality" of

[6] See Revenue Act of 1928, § 23 (b), 45 Stat. 791, 799.

[7] See also Kentucky Improvement Co. *v.* Slack, 100 U. S. 648, 658, 659; Bailey *v.* Railroad Co., 106 U. S. 109, 115, 116; compare Cary *v.* The Savings Union, 22 Wall. 38, 41.

the deal here involved would seem to be that respondent valued the protection of the higher redemption price as worth the discharge of the interest debt for which it might have obtained a judgment. Moreover, the company's argument ignores the needs of an efficient system of taxation. The administration of the income tax law would be seriously burdened if it were held that when a mortgagee bids in the property for a sum including unpaid interest, he may not be taxed on the interest received except upon an inquiry into the probable fair market value of the property.[8] "At best, evidence of value is largely a matter of opinion, especially as to real estate." *Montana Railway Co.* v. *Warren*, 137 U. S. 348, 353. There is nothing unfamiliar in taxing on the basis of the legal effect of a transaction. Income may be realized upon a change in the nature of legal rights held, though the particular taxpayer has enjoyed no addition to his economic worth. Compare *Lynch* v. *Hornby*, 247 U. S. 339, 344, 346; *United States* v. *Phellis*, 257 U. S. 156, 170, 171; *Marr* v. *United States*, 268 U. S. 536, 540; *Burnet* v. *Commonwealth Improvement Co.*, 287 U. S. 415, 419, 420. "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer." *Weiss* v. *Wiener*, 279 U. S. 333, 335. Compare *Nicol* v. *Ames*, 173 U. S. 509, 516; *Tyler* v. *United States*, 281 U. S. 497, 503.[9]

Fourth. The company contends that to tax the mortgagee as upon interest received is inconsistent with the rule declared in *Louisville Joint Stock Land Bank* v. *Radford*, 295 U. S. 555, 594, that the mortgagee is entitled to have "the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property

[8] Compare Bell's Gap R. R. Co. *v.* Pennsylvania, 134 U. S. 232, 236; New York, *ex rel.* Hatch *v.* Reardon, 204 U. S. 152, 159; Paddell *v.* City of New York, 211 U. S. 446, 449, 450; New York *v.* Latrobe, 279 U. S. 421, 427.

[9] Taxability has frequently been determined without reference to factors which the accountant, economist or business man might deem relevant to the computation of net gain. Compare Brushaber *v.* Union Pacific R. R. Co., 240 U. S. 1; Tyee Realty Co. *v.* Anderson, *id.*, 115; Weiss *v.* Wiener, 279 U. S. 333; Helvering *v.* Independent Life Insurance Co., 292 U. S. 371. The exigencies of a tax determined on an annual basis may lead to the inclusion as income of items which might be shown to involve no gain if the transactions were viewed as a whole over several years. Compare Burnet *v.* Sanford & Brooks Co., 282 U. S. 359, 364, 365; Brown *v.* Helvering, 291 U. S. 193, 199; Spring City Foundry Co. *v.* Commissioner, 292 U. S. 182, 189, 190.

itself." The charge of inconsistency is unfounded. The company exercised its right to have a sale. At the sale, it was free either to bid or to refrain from bidding. If it bid, it was free to bid such sum as it pleased. It chose to bid the full amount of principal and interest. Thus it obtained, in legal contemplation, full payment of the interest as well as the principal. To tax the company upon the full amount of interest received as a result of its own bid in no way impairs its rights as mortgagee. Compare *Texas & Pacific Ry. Co.* v. *United States*, 286 U. S. 285, 289. If the bid had been insufficient to yield full payment of the mortgage debt, principal and interest, the company would have been entitled to a judgment for the deficiency. If the company had refrained from bidding, and a stranger had bid more than the principal, the company would obviously have been taxable upon the excess up to the amount of the interest due. Perhaps it was the company's custom of bidding the full amount of principal and interest which deterred bidding by others.

Reversed.

Mr. Justice McReynolds dissenting.

The judgment below, I think, is correct and should be affirmed. A well-considered opinion supports it.

The notion that Congress intended to tax the mere hope of recouping a loss sometime in the future should be definitely rejected.

To support the assertion that here the Company collected interest, when in fact everything received was worth less than the sum loaned, requires resort to theory at war with patent facts. The Company got nothing out of which to pay the exactment; its assets were not augmented. Like imaginary "receipts" of interest often repeated and similarly burdened would hasten bankruptcy.

Divorced from reality taxation becomes sheer oppression.